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9 UNITED STATES BANKRUPTCY COURT
10 EASTERN DISTRICT OF CALIFORNIA
11 SACRAMENTO DIVISION
12

13 In re:
14 CITY OF STOCKTON, CALIFORNIA,
15 Debtor.

Case No. 2012-32118
D.C. No. OHS-1
Chapter 9

16 **CITY OF STOCKTON'S**
17 **MEMORANDUM OF FACT AND LAW**
18 **IN SUPPORT OF ITS STATEMENT OF**
19 **QUALIFICATIONS UNDER SECTION**
20 **109(C) OF THE UNITED STATES**
21 **BANKRUPTCY CODE**

22 Date: TBD
23 Time: TBD
24 Dept: TBD
25 Judge: TBD
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TABLE OF CONTENTS

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

	Page
I. INTRODUCTION	1
II. FACTUAL BACKGROUND	2
A. The City Exhausted Efforts To Avoid Insolvency.....	3
1. The City’s Declining Financial Situation.....	3
2. The City’s Attempts to Avoid Insolvency	7
a. The City Has Been Forced to Reduce Employee Positions and Reduce Employee Compensation, Either Unilaterally or Through Renegotiation.....	8
b. Severe Service Reductions Have Harmed the Community.....	11
3. When These Measures Were Insufficient, the City Was Forced to Default on Bond Payments and Delay Leave Payments to Separating Employees	14
B. The City Participated In The AB 506 Mediation Process In Good Faith, But Was Unable To Restructure Its Obligations.....	17
C. The City Filed Its Chapter 9 Petition	19
III. THE CITY IS AN ELIGIBLE DEBTOR UNDER CHAPTER 9 OF THE BANKRUPTCY CODE.....	20
A. The City Is A Municipality	21
B. The City Is Authorized By California Law To Bring Its Petition.....	21
C. The City Is Insolvent Under Section 109(c)(3).....	23
1. The Legal Standard	23
2. The City Is Insolvent Now	24
3. The City Will Be Insolvent in Fiscal Year 2012-13	24
4. The City’s Fiscal Year 2012-13 Financial Projections Confirm That the City Will Not Be Able to Pay Its Debts When Due.....	27
a. Fiscal Year 2012-13 Revenues	27
b. Fiscal Year 2012-13 Expenditures.....	30
5. Further Cuts Would Endanger the Welfare and Safety of the City’s Residents and Businesses.....	36
6. The City Has Adopted a Pendency Plan Contingent on Obtaining Relief in This Court.....	37
D. The City Desires To Effect A Plan To Adjust Its Debts	37
E. The City Has Met The Negotiation Requirement Under Section 109(c)(5)	38
1. The City Satisfied the Good Faith Negotiation Standard Set Forth in Section 109(c)(5)(B)	39
2. Alternatively, the City Was Unable to Negotiate With Its Creditors Because Such Negotiation Was Impracticable	40

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

TABLE OF CONTENTS
(continued)

Page

F. The City Filed Its Petition In Good Faith 41
IV. CONCLUSION 43

TABLE OF AUTHORITIES

Page(s)

FEDERAL CASES

<i>In re City of Bridgeport</i> , 129 B.R. 332 (Bankr. D. Conn. 1991)	passim
<i>In re McCurtain Mun. Auth.</i> , No. 07-80363, 2007 WL 4287604 (Bankr. E.D. Okla. Dec. 4, 2007)	26
<i>In re New York City Off-Track Betting Corp.</i> , 427 B.R. 256 (Bankr. S.D.N.Y. 2010)	40, 41, 42
<i>In re Pierce Cnty. Hous. Auth.</i> , 414 B.R. 702 (Bankr. W.D. Wash. 2009)	23, 40, 42
<i>Int'l Ass'n of Firefighters, Local 1186 v. City of Vallejo (In re City of Vallejo)</i> , 408 B.R. 280 (B.A.P. 9th Cir. 2009).....	passim
<i>Int'l Bhd. of Elec. Workers, Local 2376, v. City of Vallejo, Cal. (In re City of Vallejo, Cal.)</i> , 432 B.R. 262 (E.D. Cal. 2010).....	17, 21
<i>In re Valley Health Sys.</i> , 383 B.R. 156 (Bankr. C.D. Cal. 2008).....	20, 40, 43

STATE CASES

<i>Barkley v. City of Blue Lake</i> , 47 Cal. App. 4th 309 (1996).....	27
<i>Cal. Bldg. Indus. Ass'n v. Governing Bd.</i> , 206 Cal. App. 3d 212 (1988).....	29
<i>Candid Enters. v. Grossmont Union High Sch. Dist.</i> , 39 Cal. 3d 878 (1985)	30
<i>Howard Jarvis Taxpayers Ass'n v. City of Stockton</i> , No. CV030686 (San Joaquin Sup. Ct. Aug. 11, 2009)	7
<i>Stockton Police Officers Ass'n v. City of Stockton</i> , No. 39-2010-00245197 (San Joaquin Sup. Ct. July 14, 2010)	11
<i>Stockton Police Officers Ass'n v. City of Stockton</i> , No. 39-2010-00245197 (San Joaquin Sup. Ct. April 13, 2012).....	16
<i>Wells Fargo Bank, N.A. v. City of Stockton</i> , No. 39-2012-00277662 (San Joaquin Sup. Ct. Mar. 7, 2012)	16

TABLE OF CONTENTS
(continued)

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

Page

Wells Fargo Bank, N.A. v. City of Stockton,
No. 39-2012-00280741 (San Joaquin Sup. Ct. May 10, 2012)..... 16, 34

FEDERAL STATUTES

11 U.S.C. § 101(32) 21, 23
11 U.S.C. § 101(40) 21
11 U.S.C. § 109(c) 19, 20, 21, 39, 40
11 U.S.C. § 921(c) 42

STATE CONSTITUTION

Cal. Const., art. XIII A 29
Cal. Const., art. XIII C 29
Cal. Const., art. XIII D 7, 29
Cal. Const., art. XVI 26, 27

STATE STATUTES

Cal. Gov't Code § 53760 15, 17, 21
Cal. Gov't Code § 53760.1 22
Cal. Gov't Code § 53760.3 17, 18, 19, 22
Cal. Gov't Code § 66000 7

MISCELLANEOUS AUTHORITIES

2011 Cal. Stat. ch. 675 18
Stockton City Emps. Ass'n v. City of Stockton,
No. 774-M (PERB grievance filed Dec. 20, 2011) 11
Stockton Police Officers Ass'n v. City of Stockton,
No. 04-11 (PERB grievance filed July 13, 2011) 11

1 The City of Stockton, California (the “City” of “Stockton”), submits the following
2 Memorandum of Fact and Law in support of its Statement of Qualifications Under Section 109(c)
3 of the United States Bankruptcy Code, Dkt. No. 5:

4 **I. INTRODUCTION**

5 The City is seeking relief under chapter 9 of the Bankruptcy Code because it has
6 exhausted all other options. Its financial condition has deteriorated over the past four years to the
7 point where its General Fund is insolvent now and will be insolvent for the fiscal year beginning
8 July 1, 2012. The collapse of the housing market in California’s Central Valley and the Great
9 Recession, among other factors, have significantly decreased General Fund revenues while,
10 despite having undertaken severe cost-saving measures, the City’s operational costs have
11 remained flat or increased.

12 Rebuilding revenue streams in the short term is nearly impossible. The City exhausted all
13 reserves long ago. Without voter approval, state law forbids the General Fund from borrowing
14 money from other funds or from private creditors unless the City can repay the advances from
15 revenues raised in the same fiscal year. The City cannot do so. Raising taxes also is illegal
16 without voter approval. And voter approval of new debt or new taxes is highly unlikely in a city
17 with 20% unemployment, a high rate of foreclosures, a high level of poverty, and widespread
18 distrust of the City’s past fiscal practices.

19 Because raising revenues has not been a realistic tool for solving its chronic budget
20 deficits, the City has resorted to increasingly drastic cost-cutting measures. It balanced its fiscal
21 year 2009-10 and 2010-11 budgets largely by reducing services and employee compensation and
22 benefits. These actions were necessary, but came with a cost. Stockton has the highest crime rate
23 for a large city in California, but has 22% fewer police officers on the streets than it did four years
24 ago. Violent crime, murders, gang activity, and drug trafficking are on the rise. Fire protection,
25 building, vehicle, road, and tree maintenance, and community programs also have been slashed.

26 Despite these efforts, earlier this year the City still faced the prospect of running out of
27 money before June 30, the end of the 2011-12 fiscal year. Just to remain cash-solvent for the
28 remaining months of 2011-12, the City defaulted on payments to capital markets creditors,

1 delayed making payments to retiring employees, and transferred the last available unrestricted
2 money—originally earmarked for repairs and maintenance—into the General Fund. These
3 desperation measures gave the City enough liquidity to get through the fiscal year, but they
4 provided no long-term relief.

5 Even after four years of belt-tightening, financial projections demonstrate that the General
6 Fund deficit in fiscal year 2012-13 will be almost \$26 million. Out of necessity, the City has
7 reduced or eliminated funding for almost all General Fund programs and services below levels
8 that the City views as minimally acceptable. Little is left to cut in these areas, and what
9 reductions could be made are not nearly enough to even approach solving the City’s financial
10 difficulties.

11 Confronted with this fundamental imbalance, in February 2012, the City entered the state-
12 mandated “neutral evaluation process” in an attempt to resolve its outstanding debts consensually,
13 without the need for a chapter 9 case. From that time until a few days before the filing of its
14 chapter 9 petition, with the assistance of an expert mediator, the City and many of its creditors
15 worked diligently and in good faith to identify solutions acceptable to all parties that would
16 prevent General Fund insolvency in the short term and provide a structure for the long term that
17 would return the City to financial health and reestablish General Fund cash reserves. However,
18 the City and its creditors were unable to reach either a short- or a longer-term agreement. Faced
19 again with insolvency, and with no time to reach a deal before fiscal year 2012-13 started, the
20 City had no option other than to seek bankruptcy relief.

21 In connection with its petition, the City filed its Statement of Qualifications Under Section
22 109(c), Dkt. No. 5, in which it certified that it satisfies each of the five eligibility criteria set forth
23 in Section 109(c). Below, the City details the facts and law that demonstrate that its certification
24 is correct, and that the City is eligible to be a debtor in a chapter 9 case.

25 **II. FACTUAL BACKGROUND**

26 The City filed its chapter 9 petition on June 28, 2012. The City took this action only after
27 extensive efforts to find and implement a viable solution to its financial situation that would
28

1 return the City to long-term solvency while avoiding the need for filing the petition. Those
2 efforts proved unsuccessful.

3 **A. The City Exhausted Efforts To Avoid Insolvency**

4 The City has been grappling with massive budget deficits for the past several years. *See*
5 Declaration of Laurie Montes, ¶ 3. In simple terms, in recent years the City's General Fund
6 revenues have plummeted while its General Fund expenditures have either remained the same or
7 risen. *Id.* In each of the past three springs, the City has projected that it would operate at a deficit
8 of over \$20 million during the following fiscal year. *Id.* To close these gaps, the City has
9 depleted reserves, renegotiated labor contracts and unilaterally imposed compensation reductions
10 when negotiation was unsuccessful, cut jobs, cut services, defaulted on bond payments, deferred
11 payouts to retiring employees, and otherwise used every tool at its disposal to maintain sufficient
12 liquidity to sustain vital operations. *Id.* ¶ 4. Despite these efforts, the City effectively has no
13 remaining reserves and is facing an operating shortfall of almost \$26 million for fiscal year 2012-
14 13, which begins July 1, 2012. *Id.* ¶ 5; Declaration of Vanessa Burke, ¶ 11. This means that the
15 City is insolvent. The City's deficit is projected to grow to \$47 million per year within three
16 years, in large part due to the continuing stagnation in General Fund revenues, caused by the poor
17 housing market and economy, and by increasing costs that the City cannot unilaterally reduce
18 without consequences. Burke Decl., ¶ 11.

19 **1. The City's Declining Financial Situation**

20 The Great Recession hit Stockton hard. Housing prices plunged, causing property tax
21 revenues to fall, and unemployment has soared during the last five years, resulting in a decline in
22 sales tax revenues. Meanwhile, the City's expenses have remained the same or increased. Poor
23 decisions, lax management, and bad luck also have exacerbated the City's financial woes.

24 **Economic Crises Have Caused the City's Revenues to Plummet**

25 Starting in the early 2000s, population and development surged in Stockton. As in other
26 housing-boom communities throughout the country, developers built and built, and people bought
27 and bought. *See, e.g.,* Sam Quinones, *A Cutting-Edge City: Stockton?*, L.A. TIMES, June 25,
28 2006, at B1 ("The long-beleaguered town is at the vanguard of the Central Valley's

1 transformation from farm belt to the state’s next big population center”). Between 2000 and
 2 2007, the City of 243,000 added 42,000 new residents. Montes Decl., ¶ 6 & Ex. A. As home
 3 values increased, the City’s property tax revenues more than doubled from \$16.5 million in fiscal
 4 year 1999-2000 to \$37.1 million¹ in fiscal year 2007-08. *Id.* ¶ 7 & Ex. B. Sales and use taxes
 5 also rose by 65% between 2000 and 2006 as more people lived, worked, and spent in Stockton.
 6 *Id.* ¶ 8 & Ex. C. The unemployment rate, though historically high compared to other cities in
 7 California, dipped below 8%. *Id.* ¶ 9 & Ex. D.

8 Stockton’s dependence on housing made the City ground zero in the foreclosure crisis that
 9 shook the nation in 2008. Montes Decl., ¶ 10 & Ex. E; *see, e.g.*, Andrew Clark, *Welcome to Sub-*
 10 *Prime Capital, USA*, THE GUARDIAN, July 28, 2008, at 23 (“It is easy to spot a repossessed home
 11 in Stockton, the sub-prime capital of the United States and, indeed, of the world.”); Steve
 12 Chawkins, *A Magical Misery Tour in Stockton*, L.A. TIMES, Dec. 13, 2007 (“expect[ing] the
 13 rising equity in their home to refinance the adjustable loan” “was a bet that backfired”). Since
 14 then, it has been at or near the top of nationwide foreclosure rates. Montes Decl., ¶ 11 & Ex. F.
 15 A study of U.S. home loans in 2011 ranked Stockton second highest in loans “underwater” at
 16 56% (second only to Las Vegas at 66%). *Id.* At 57.2%, the City currently ranks fourth out of 306
 17 metropolitan areas nationwide in magnitude of property value reduction over the past five years.
 18 *Id.* The median home price, which peaked at \$397,000 in 2006, has averaged \$117,000 since
 19 2009. *Id.* ¶ 12 & Ex. G. The number of new residential dwelling unit permits issued dropped
 20 from an average of 2,988 annually during fiscal years 2002-03 through 2004-05 to an average of
 21 134 annually during fiscal years 2008-09 through 2011-2012. *Id.* As a result, development-
 22 related fees and capital funding virtually vanished. *Id.*

23 This swift economic reversal affected adversely the City’s residents and, by extension,
 24 impaired its major revenue streams. Montes Decl., ¶ 13. Revenues fell and kept falling. The
 25 collapse in property values and the rash of foreclosures reduced the City’s gross property tax
 26 collections (including property tax in lieu of VLF²) from \$59.8 million in fiscal 2007-08 to \$44.4

27 ¹ Excluding property taxes in lieu of vehicle license fees, as explained in footnote 2.

28 ² The 2003-04 state budget contained a permanent reduction in vehicle license fee (VLF) rate from 2.0% to 0.65%
 (its then-current rate), with an elimination of the \$4.4 billion in “backfill” that was being paid by the state to local

1 million in fiscal 2011-12, a decrease of \$15.4 million or 26%, Montes Decl., ¶ 13; further
 2 decreases are expected in 2012-13. Burke Decl., ¶ 23. Not only were Stockton's residents losing
 3 their homes; they were losing their jobs too. The City's unemployment rate steadily rose from
 4 early 2007, peaking in early 2011 at over 22%. Montes Decl., ¶ 14 & Ex. D. Unemployment
 5 remains in the 20% range, over double the national rate of 8.2%. *Id.* Stockton's poverty rate of
 6 22.3% is half again as high as the California average of 14.9%, and the City ranks 11th highest of
 7 the 122 largest cities in California surveyed by the U.S. Census Bureau in 2009. *Id.* ¶ 15 & Ex.
 8 H. The City's median household income of \$45,730 is three-quarters of the California average of
 9 \$59,500, ranking 15th lowest of the 122 metropolitan areas in the same Census study. *Id.*

10 As Stockton residents lost their jobs and houses, they spent less. Sales and use taxes
 11 collected by the City fell from a peak in fiscal 2005-06 of \$47.0 million to \$32.7 million in fiscal
 12 2009-10, a decline of \$14.3 million or 30%. Montes Decl., ¶ 16 & Ex. C. Expected revenue of
 13 \$38.9 million in fiscal 2012-13 is still 19% below peak year levels. Burke Decl., ¶ 25. Other
 14 revenue streams likewise were adversely affected. Montes Decl., ¶ 16 & Ex. I.

15 *Current Expenses and Long-Term Obligations Remained the Same or Rose*

16 Had the City prepared for a downturn, it would be more fiscally stable now. When the
 17 City was flush with cash, however, it made decisions based on the premise that such revenue
 18 growth could be counted on to continue indefinitely. Any economic reversal would have exposed
 19 the short-sightedness of this strategy. The severe economic reversals experienced during the
 20 Great Recession, though, not only exposed it but also deeply thrust Stockton into insolvency.

21 The rapid increase in the City's population between 2000 and 2007, and a more moderate
 22 increase since then, meant an increasing demand for City services. The accompanying
 23 development boom added to the City's obligation to provide infrastructure support and essential
 24 public services. Some of these obligations remain, though the City aggressively sought to reduce
 25 them as its tax base shrank.

26
 27 government to compensate for local revenue losses due to the lower VLF rate. Montes Decl., ¶ 13 n.2. This
 28 "backfill" was replaced dollar-for-dollar with a like amount of property taxes taken from the schools; the state then
 increased aid to schools to compensate for their loss. *Id.* Property tax received in lieu of VLF as part of this swap in
 funds rises and falls in accordance with changes in the secured roll, and is otherwise treated as property tax. *Id.*

1 The combination of expenses naturally increasing along with population growth, of poor
2 decisions, of shoddy management and accounting practices, and of some bad luck resulted in the
3 City being saddled with many obligations that it could no longer afford to pay. Some of these
4 included:

5 ***Unsustainable retiree health benefits.*** In the 1990s, the City greatly expanded its retiree
6 health insurance commitments to levels well beyond what other cities offered, but did not fund
7 them on an actuarially sound basis. The City has been funding these obligations on a pay-as-you-
8 go basis, and not setting aside any money to meet future obligations. Its current unfunded
9 liability for retiree health benefits now totals \$417 million, reduced from approximately \$550
10 million by Council action redesigning plan benefits in fiscal year 2010-11. The City's direct
11 costs have inexorably risen, doubling from 2006-07 to 2012-13. In fiscal year 2013-14, for the
12 first time, the City will be paying more for retiree health care than for active employee health
13 care. Due to the combination of growth in the number of retirees receiving benefits and medical
14 inflation, the City's costs for retiree medical expenses are expected to double in the next 10 years.
15 *See infra* Section III(C)(4)(b)(4).

16 ***Unsustainable labor costs.*** Though not unique among California cities in this regard,
17 during better economic times the City approved labor contracts that were neither transparent nor
18 sustainable. Automatic salary increases were tied to other cities that were not reasonable
19 comparisons to Stockton's labor market. The base salary used for comparison excluded many
20 "additional pays" for longevity, education and specialty assignments, so that while base pay
21 might not have appeared unreasonable, total compensation grew higher than the labor market.
22 *See infra* Section III(C)(4)(b)(1).

23 ***Excessive debt burden.*** For different reasons, including urban renewal and refinancing of
24 its pension obligations, the City incurred large amounts of debt over the last decade. It structured
25 its liability on the assumption that the revenues produced by economic growth would continue to
26 rise at a rate that has proven unsustainable. When the economy crashed, the General Fund had to
27 backfill obligations supported by growth-related payment streams that proved inadequate. *See*
28 *infra* Section III(C)(4)(b)(3).

1 **2. The City’s Attempts to Avoid Insolvency**

2 The net result of these trends was that, as early as 2008, the gap between General Fund
3 revenues and General Fund expenses began to widen substantially as revenues dropped and
4 expenses remained static or increased. Since that time, the City has addressed chronic deficits in
5 the General Fund and has implemented increasingly drastic measures to balance the General
6 Fund, cutting \$90 million in General Fund expenses over the past three years.

7 This focus on the General Fund is warranted because it is the fund that accounts for most
8 municipal services—police, fire, public works, administrative services, recreation, and cultural
9 programs. Burke Decl., ¶¶ 5-8. Unlike almost any other fund, the revenues of the General Fund
10 may be spent on any legal municipal purpose. *Id.* Under generally accepted accounting
11 principles (“GAAP”), municipalities account for their activities in separate funds as a means of
12 segregating resources by source and purpose and to allow a reporting process that not only
13 reflects the financial activities of each of the funds but also shows compliance with the numerous
14 restrictions that are placed on many of the resource streams of the other funds. *Id.* For example,
15 many cities adopt fees and then restrict the use of the proceeds because state law limits the use of
16 the fees to specific purposes for which the fees are established.³ *Id.* Also, federal, state, and
17 private grants contain requirements that restrict how and for what purpose grant monies may be
18 spent. *Id.* In addition, Article XIID, Section 6, of the California Constitution restricts how, for
19 example, the fees charged for water and sewer services are determined and the purposes for
20 which they may lawfully be spent. *Id.* The City was found to have violated such laws in the past,
21 resulting in a \$20.3 million judgment arising from a lawsuit brought against it by the Howard
22 Jarvis Taxpayers’ Association, which with interest will cost the City \$33.8 million through 2040.
23 Burke Decl., ¶ 6; *Howard Jarvis Taxpayers Ass’n v. City of Stockton*, No. CV030686 (San
24 Joaquin Super. Ct. Aug. 11, 2009).

25 ///

26 ///

27 _____
28 ³ See, e.g., Cal. Gov’t Code §§ 66000 *et seq.* (the so-called “Mitigation Fee Act,” which allows cities to impose development impact fees for specific projects).

1 a. **The City Has Been Forced to Reduce Employee Positions and**
 2 **Reduce Employee Compensation, Either Unilaterally or**
 3 **Through Renegotiation**

4 Labor costs have been and remain by far the City’s largest General Fund expenditure, with
 5 police and fire compensation and benefits alone representing approximately 68% of General Fund
 6 expenditures in fiscal year 2012-13. Burke Decl., ¶ 36. Because such expenses may lawfully be
 7 paid only from the General Fund, over the last few years, the City looked primarily to balance its
 8 budgets through two strategies: (1) negotiating or imposing reductions in employee costs, with
 9 the goal of continuing to provide critical, albeit reduced, services to the public; and (2)
 10 eliminating many City positions, which necessarily resulted in significant reductions to service
 11 levels provided to the community. Montes Decl., ¶ 18.

12 Most City employees are represented by one of nine labor associations, each of which is a
 13 party with the City in a collective bargaining agreement (collectively, the “CBAs”). Declaration
 14 of Ann Goodrich, ¶ 3. Among other things, the CBAs provide the terms that determine the
 15 compensation represented employees receive, including base pay, overtime, health and medical
 16 benefits, pension and retiree health benefits, and other compensation components, such as
 17 vacation accrual. *Id.* Absent a fiscal emergency, California law does not permit the City to
 18 unilaterally modify its CBAs that have not expired. *Id.*

19 Beginning in 2008, the City began to reduce pay and benefits costs and imposed
 20 furloughs. Goodrich Decl., ¶ 6; Montes Decl., ¶ 19. In the following years, the City offered early
 21 retirement incentives, and as the fiscal situation grew more desperate, furlough hours grew.
 22 Goodrich Decl., ¶ 6; Montes Decl., ¶ 19. It then began to negotiate for voluntary reductions in
 23 employee compensation and benefits (including by eliminating cost-of-living increases), imposed
 24 a hiring freeze, and reduced City operational hours in many departments. Goodrich Decl., ¶ 6;
 25 Montes Decl., ¶ 19. It also laid off employees, including police officers. Goodrich Decl., ¶ 6;
 26 Montes Decl., ¶ 19.

27 Even while attempting to minimize layoffs through furloughs, contract renegotiation, and
 28 early retirement offers, between fiscal years 2008-09 and 2011-12, the City reduced its total full-
 time workforce by approximately 25%—from 1,886 employees to 1,414 employees, a drop of

1 472 positions. Montes Decl., ¶ 20. The percentage reduction to General Fund full-time positions
2 was higher, at 31% or 424 positions. *Id.* Those cuts included 98 sworn police positions (a 25%
3 reduction), 47 non-sworn police positions (a 20% reduction), 76 fire positions (a 30% reduction),
4 and 203 non-safety positions (a 43% reduction). *Id.*

5 Despite these efforts, by May 2010, the City still faced a projected \$23 million budget
6 deficit in fiscal year 2010-2011. Montes Decl., ¶ 21 & Ex. J. On May 26, 2010, staff presented
7 the City Council with a bleak picture of the City's financial situation. *Id.* Even though the City
8 already had reduced employee positions, renegotiated some contracts, and cut funding to
9 community services, low revenues and high labor and retiree costs still left the City unable to
10 balance its budget. *Id.*

11 Faced with no other option, on May 26, 2010, the City Council declared a state of fiscal
12 emergency and authorized the City Manager to "take appropriate and lawful measures that will
13 achieve a balanced budget for fiscal year 2010-2011." Montes Decl., ¶ 21 & Ex. J (City Council
14 resolution). One month later, following fruitless negotiations with its labor unions and acting
15 under the fiscal emergency, the City Council unilaterally imposed terms that diverged from the
16 terms of existing police and fire CBAs. Montes Decl., ¶ 22 & Ex. K; Goodrich Decl., ¶ 7. In
17 particular, among other things the emergency measures temporarily suspended scheduled pay
18 increases from taking effect during fiscal year 2010-11, restricted time off, and closed a fire truck
19 company. Montes Decl., ¶ 22 & Ex. K; Goodrich Decl., ¶ 7. Only by doing so was the City able
20 to obtain approximately \$23 million in savings and limp into another fiscal year with a balanced
21 budget. Montes Decl., ¶ 22.

22 Despite such radical surgery, the long-term structural challenges remained. Montes Decl.,
23 ¶ 23. Revenues remained low and labor costs, though reduced markedly, were still higher than
24 the City could afford to pay. *Id.* Retiree medical and debt service costs also were set to increase.
25 *Id.* Thus, on February 15, 2011, as part of an update on the fiscal emergency, staff recommended
26 that the City Council continue the fiscal emergency. *Id.* ¶ 23 & Ex. L. Staff concluded that
27 without the continuation of the emergency measures, the City would have had a negative cash
28 balance by the end of the fiscal year. *Id.* at 3. Staff also alerted the City Council that "the City

1 continues to face dramatic fiscal challenges.” *Id.* Another deficit was projected, with the main
2 drivers being continued drops in revenue, scheduled wage increases for four of the City’s largest
3 labor groups, increasing health care costs for employees and retirees, increases in pension
4 contribution rates required by CalPERS, and potential state budget effects. *Id.* at 4. It also
5 warned the City Council concerning the unfunded retiree healthcare liability: “In order to
6 properly fund this liability the City should be setting aside an additional \$27 million on an annual
7 basis. The City has not been setting these funds aside.” *Id.*

8 Following this sobering update, staff returned to the City Council in May 2011 to work
9 out a mechanism for balancing the fiscal year 2011-12 budget. Montes Decl., ¶ 24. The good
10 news was that the prior years’ steep decline was expected to level off (a forecast that proved
11 inaccurate). *Id.* Despite this, the same structural imbalance that bedeviled the budget process the
12 prior year remained: costs were still significantly greater than revenue. *Id.* As staff’s detailed
13 analysis demonstrated, the City was facing a staggering \$37 million deficit in fiscal year 2011-12
14 in the face of the “restoration of previously withheld salary increases, new scheduled salary
15 increase for 2011-12, and soaring health and pension costs.” *Id.* ¶ 25 & Ex. M at 2.

16 After careful analysis, balancing the budget just by service reductions was deemed an
17 unacceptable approach, though some service reductions would be necessary. Montes Decl., ¶ 25
18 & Ex. M. The reason was that the health, safety, and welfare of City residents would have been
19 jeopardized by such extreme staffing reductions. *Id.* at 48. Accordingly, in May and June 2011,
20 staff proposed, and the City Council adopted, resolutions continuing the City’s fiscal emergency.
21 *Id.* ¶ 26 & Ex. M (resolutions). With the City Manager exercising his authority under the fiscal
22 emergency, the City balanced the fiscal year 2011-12 budget, but only by continuing the prior
23 year’s fiscal emergency and obtaining an additional \$25 million in employee compensation
24 reductions and \$12 million in staffing reductions, mainly in the Fire Department. *Id.* This was
25 the fourth consecutive year in which some form of compensation reduction or service reduction
26 was adopted, and the second year in a row in which severe cuts to compensation and services
27 occurred. *Id.*

28 ///

1 As the financial picture worsened, many labor groups were willing to renegotiate closed
2 contracts to reduce those compensation and benefits that exceeded the relevant labor market.
3 Goodrich Decl. ¶ 10. The City achieved significant savings through voluntary reductions. *Id.*
4 However, the Stockton Police Officers Association (“SPOA”) and the Stockton City Employees
5 Association (“SCEA”), two of the City’s largest labor groups (which combined represent the
6 majority of Stockton employees), were not willing to renegotiate their CBAs. In 2010, SPOA
7 sued and in 2011 both brought administrative actions against the City for unilaterally modifying
8 the terms of closed CBAs. *See Stockton Police Officers Ass’n v. City of Stockton*, No. 39-2010-
9 00245197 (San Joaquin Sup. Ct. July 14, 2010); *Stockton City Emps. Ass’n v. City of Stockton*,
10 Case No. 774-M (grievance filed Dec. 20, 2011); *Stockton Police Officers Ass’n v. City of*
11 *Stockton*, No. 04-11 (grievance filed July 13, 2011); Goodrich Decl., ¶ 11. Fire Department
12 employees also sued the City, but later dismissed their complaint. Goodrich Decl., ¶ 11. The
13 SPOA and SCEA actions remain pending, Goodrich Decl., ¶ 12, and are stayed by this
14 bankruptcy case. But if the labor groups ultimately succeed, the City may owe them at least
15 \$12.5 million from the General Fund for savings imposed between 2010 and now—a sum that the
16 City does not have cash to pay and would simply add to its deficit projections. Goodrich Decl., ¶
17 12; Burke Decl., ¶ 32.

18 **b. Severe Service Reductions Have Harmed the Community.**

19 As noted above, in addition to significant reductions in labor costs, to balance its General
20 Fund over the last several years the City has been forced to make severe reductions in staffing and
21 services, with serious repercussions to the safety and welfare of the City’s residents. Montes
22 Decl., ¶ 27. The primary form of service reductions has been the elimination of City positions,
23 either through layoffs or through not filling vacancies. *Id.* These staff reductions have
24 necessarily translated into service reductions. *Id.* This can be seen most markedly with respect to
25 public safety, which has been a necessary target of reductions because it accounts for such a large
26 proportion of the General Fund. *Id.* ¶ 28.

27 Over the last five years, in a city with an already high crime rate, Stockton has been forced
28 to cut 98 officers or 22% from the sworn police force. Montes Decl., ¶ 28; Declaration of Eric

1 Jones, ¶¶ 5-6. In 2007-08, the Stockton Police Department had 441 sworn officers, or
2 approximately 1.52 officers per 1,000 residents. Jones Decl., ¶ 5. Even at that time, the goal was
3 to increase the staffing ratio to approximately 550 (a ratio of approximately 2.0 per 1,000
4 residents) following principles outlined in a report prepared for the City in 2006 by a consultant,
5 Dr. Anthony Braga. *Id.* ¶ 5 & Ex. A. The goal of the Braga report was to deal with the increased
6 population, the increasing crime rate, and the gang and narcotics problems that have plagued
7 Stockton for decades. *Id.* ¶ 3 & Ex. A.

8 Instead, after years of cuts, today the Stockton Police Department has around 343 sworn
9 officer positions, or approximately 1.16 officers per 1,000 residents. *Id.* ¶ 6. With difficulties in
10 retention and recruitment, only 320 of these 343 budgeted positions are filled at this time. *Id.*
11 This is the lowest ratio in the state for cities of more than 250,000 residents. *Id.* ¶ 7. To reach the
12 goal of 2.0 officers per 1000 residents in 2012 would require another 247 officers; at the cost per
13 officer the City currently spends, this would cost around \$48 million annually. *Id.* ¶ 7.

14 These cuts are felt acutely because of the particular need for police services in the City.
15 Jones Decl., ¶¶ 8-11. The City has the highest total crime rate per capita for any city with a
16 population of 100,000 or greater in California. *Id.* ¶ 9. While violent crime rates dropped 5.5%
17 nationwide in 2010, that year they were up in Stockton, which ranked tenth in the United States
18 with 13.81 violent crimes per 1,000 residents. *Id.* In 2011, there were 58 homicides in Stockton,
19 an all-time record. *Id.* ¶ 10. The City is on pace this calendar year to match or exceed that
20 number. *Id.* Gun violence is up 30% in 2012, as compared to last year. *Id.* ¶ 11. Residents
21 justifiably feel vulnerable. See Alison Veshkin, *Stockton Slide to Bankruptcy Measured in More*
22 *Funerals*, BLOOMBERG.COM, June 20, 2012 (“The shortage in police is leaving everything wide
23 open to where people feel they can get away with anything.”).

24 Other consequences of these service reductions have included: during certain times of
25 peak activity, the Police Department is limited to responding only to crimes-in-progress. Jones
26 Decl., ¶ 8. The elimination of law enforcement presence on school campuses, in the downtown
27 core, and at community events, has lead to rises in juvenile crime, gang activity, and crime in
28 public areas. *Id.* The elimination of gang-focused and drug-focused missions, including the

1 Narcotics Enforcement Team, has resulted in an increase of gang-related homicides and drug
2 trafficking within the City. *Id.* The elimination of Community Service Officers has severely
3 limited the ability of the department to attend community meetings and respond to non-
4 emergency accidents and calls for service, including traffic control and parking enforcement
5 (which has also reduced traffic violation revenue). *Id.*

6 Similar reductions in fire services have affected the community. Montes Decl., ¶ 28. The
7 Fire Department responds to many more calls per firefighter than do departments in comparable
8 jurisdictions. *Id.* Due to reductions in the number of trucks on duty on account of personnel
9 reductions, the arrival of a second truck at structure fires is often delayed, potentially placing
10 people and structures at greater risk. *Id.* Alarmingly, the Fire Department has been forced to
11 dispatch mechanics with its crews in the event that aged equipment breaks down at a major fire.
12 *Id.*

13 The effects of the City's budget crisis have not been limited to public safety. Montes
14 Decl., ¶ 29. The General Fund also is the source of payment for public works, libraries,
15 recreation, and other quality-of-life programs on which the City's residents rely. *Id.* The City has
16 been compelled to drastically cut back these expenditures through elimination of positions and
17 work hours, reduction in operational hours, and the outright shutdown of certain programs. *Id.* It
18 has eliminated almost half—43%—of non-safety positions since fiscal year 2008-09. *Id.*

19 For public works, these reductions have meant sharp drops in maintenance, repair, and
20 replacement budgets. Montes Decl., ¶ 30. As of today, approximately 172 City vehicles are past
21 their useful life. *Id.* Even for police and fire vehicles, no future reserves exist, and it is likely that
22 aging fleets will not be replaced on a timely basis in the future. *Id.* Though the City's roads
23 currently score as "fair" based on the commonly used Pavement Condition Index metric, they are
24 expected to deteriorate going forward as the City lacks the funding to maintain them. *Id.* Tree
25 and parks maintenance has been deferred. *Id.* Library renovations have been canceled. *Id.*
26 Applicants for permits and other approvals, along with those seeking information, endure longer
27 wait times. *Id.* City Hall itself is badly in need of over a million dollars in repairs, including a
28 new roof and HVAC system. *Id.*; see, e.g., *Stockton Readies Bankruptcy Plan If Creditor Talks*

1 *Fail*, WALL ST. J., June 7, 2012, at A6 (“At city hall, rats roam the building and employees avoid
2 drinking the tap water”).

3 The direct effects on the community have been substantial. Montes Decl., ¶ 31. Over the
4 last few years, the City has been forced to close one community center, reduce recreation classes
5 offered to the public, reduce after-school programs (despite the number of at-risk youth), and
6 shorten hours of operation at the Pixie Woods amusement park and the Oak Park Senior Center.
7 *Id.* Despite the City’s high rate of illiteracy⁴, it has closed a library branch and slashed the
8 following library services: books and materials costs were cut by 50%, hours were reduced in
9 City of Stockton libraries by 48%, and programs for at-risk schoolchildren were cancelled. *Id.*
10 Also cancelled were special events like the formerly annual July 4 Celebration. *Id.* The City also
11 eliminated its support for the Silver Lake High Sierra Camp. *Id.*

12 **3. When These Measures Were Insufficient, the City Was Forced to**
13 **Default on Bond Payments and Delay Leave Payments to Separating**
14 **Employees.**

15 The City was able to balance its last two budgets only by obtaining or imposing the
16 compensation reductions and service cuts described above. Montes Decl., ¶ 32. Despite these
17 drastic steps, in late 2011 and early 2012, the City’s financial condition continued to deteriorate to
18 the point that staff feared that the City would run out of money before the end of fiscal year 2011-
19 12. *Id.* ¶ 32. In August and again in October 2011, staff alerted the City Council of continuing
20 declines in property tax revenues, risks relating to the State of California’s elimination of
21 redevelopment agencies, and other budget risks. *Id.* ¶ 33 & Exs. N & O. Consistent with the City
22 Council’s adopted goal of “Getting Our Fiscal House in Order” in 2011, staff also presented for
23 City Council approval various measures for increasing the transparency and integrity of the City’s
24 accounting practices. *Id.* These included correcting questionable past practices relating to inter-
25 fund loans, deficit spending, and lack of clarity regarding the distinction between restricted and
26 unrestricted funds. *Id.*

27 ⁴ In 2011, Stockton ranked 75th of 79 cities over 250,000 population in America’s Most Literate Cities study by
28 Central Connecticut State University, which measures six indicators of literacy: newspaper circulation, number of
bookstores, library resources, periodical publishing resources, educational attainment, and Internet resources. See
Montes Decl., ¶ 31 & Ex. V.

1 In February 2012, staff's assessment of the dire budget situation was confirmed by a
2 financial assessment report delivered by Management Partners, an outside consultant employed
3 by the City to deliver a second opinion. Montes Decl., ¶ 34 & Ex. P. Among other things, the
4 Management Partners report found that the City (1) could be considered insolvent from a service
5 delivery and budget perspective; and (2) was nearly cash-insolvent and was likely to run out of
6 unrestricted available fund balances before the end of the fiscal year unless action was taken. *Id.*

7 Accordingly, for the February 28, 2012 City Council meeting, staff prepared for the City
8 Council a report that contained recommendations for maintaining operational liquidity through
9 the remainder of the fiscal year while also initiating the "neutral evaluation process" called for by
10 California law as a vehicle for avoiding chapter 9 and as a prerequisite to filing a chapter 9
11 petition ("AB 506 process"). Cal. Gov't Code § 53760; Montes Decl., ¶ 35 & Ex. Q.

12 The staff report described how the City had to restate the City's 2010-11 ending General
13 Fund balance from an estimated approximately \$722,000 positive to a deficit of \$6.6 million.
14 Montes Decl., ¶ 36 & Ex. Q. Among other things, the causes of this significant reduction
15 included a \$3.9 million subsidy to the Redevelopment Agency following its dissolution by the
16 State Legislature. *Id.* at 8. Also causing this restatement were material accounting errors in fiscal
17 years 2009-10 and 2010-2011, uncovered by City staff as part of its thorough review begun in
18 2011. *Id.* The report detailed how changes in revenues and expenses tentatively left the General
19 Fund with an \$8.7 million fund balance deficit for fiscal year 2011-12 (\$3.5 million of which was
20 budgeted for the AB 506 process and bankruptcy preparation). *Id.* at 12-15. Combined, these
21 deficits represented a projected \$15.2 million deficit in the General Fund by June 30, 2012, the
22 end of the 2011-12 fiscal year. *Id.* at 17.

23 To "avoid an uncontrolled insolvency or default," staff proposed, and the City Council
24 adopted, several measures. Montes Decl., ¶ 37 & Ex. Q at 17-20. First, the City swept what
25 unrestricted funds were still available into the General Fund. *Id.* This meant canceling
26 maintenance and repair projects, emptying reserve funds for equipment and vehicle replacement,
27 taking back funding that previously had been devoted to the arts, and delaying relocation of City
28 Hall to its new building. *Id.* It also increased the City's long-term exposure by making the

1 General Fund the financial backstop for some of the funds that the City was now transferring into
2 the General Fund. *Id.*

3 Second, the City continued the state of emergency it declared on May 17, 2011, as part of
4 its imposition of compensation and benefits reductions. Montes Decl., ¶ 38 & Ex. Q. Under the
5 continued state of emergency, the City Council authorized the temporary suspension of certain
6 payments that the City would otherwise have paid to separating employees. *Id.* at 33-34. These
7 payments included compensation for accrued vacation hours, sick leave hours, and holiday leave
8 hours. *Id.*

9 Finally, and only as a last resort, the City elected not to pay over \$2 million in debt service
10 owed between March 2012 and June 2012. Montes Decl., ¶ 39 & Ex. Q at 33-34. This decision
11 marked the first time in its four-year-long fiscal crisis—and indeed, in the City’s over 150-year
12 history—that the City had missed a payment to its capital markets creditors. *Id.*

13 All of these were hard choices with serious consequences. Montes Decl., ¶ 40. Sweeping
14 the remaining unrestricted funds increased the General Fund’s long-term fiscal exposure and
15 diverted much-needed repair and maintenance funds. *Id.* Delaying leave payments adversely
16 affected separating longtime City employees who were counting on the money; it also provoked a
17 lawsuit against the City. *See Stockton Police Officers Ass’n v. City of Stockton*, No. 39-2010-
18 00245197 (San Joaquin Super. Ct. April 13, 2012) (order denying request for preliminary
19 injunction); Montes Decl., ¶ 40. Missing bond payments, as the City recognized, constituted an
20 event of default on its financial obligations. Montes Decl., ¶ 40. It also brought on lawsuits, and
21 since March 2012 the bond trustee has been operating three parking facilities in the City, and now
22 has control of the City building that was to be the new City Hall. Montes Decl., ¶ 40 & Ex. S;
23 *See Wells Fargo Bank, N.A. v. City of Stockton*, No. 39-2012-00277662 (San Joaquin Super. Ct.
24 Mar. 7, 2012) (parking garages); Randall Jensen, *Bond Trustee Gets Three Parking Garages in*
25 *Stockton*, THE BOND BUYER, April 16, 2012; *Wells Fargo Bank, N.A. v. City of Stockton*, No. 39-
26 2012-00280741 (San Joaquin Super. Ct. May 10, 2012) (400 East Main building).

27 The City Council determined, nevertheless, that these measures were necessary to allow
28 the City sufficient liquidity to continue to operate through the end of June 2012. Montes Decl., ¶

1 40 & Ex. Q. It also recognized, though, that they were one-time rather than permanent measures,
 2 that absent a restructuring of the city’s legal obligations, these payments would eventually have to
 3 be paid, and that a long-term solution was needed. *Id.* In the same report, staff projected yet
 4 another \$20 million to \$38 million General Fund deficit in fiscal year 2012-13, with the
 5 difference largely accounting for the uncertain result of the litigation between SPOA and SCEA
 6 and the City over the City’s unilateral imposition of wage and benefit concessions under the fiscal
 7 emergency. *Id.* With little left to cut, and with no foreseeable revenue increases, the City had no
 8 other option than to examine permanent restructuring options, including bankruptcy.

9 In light of the “immediate and severe fiscal crisis” and the fact that the City “is or likely
 10 will become unable to meets its financial obligations as and when those obligations are due or
 11 become due,” staff recommended that the City enter the “neutral evaluation process” established
 12 by California law to avoid chapter 9 filings. The City Council adopted staff’s recommendation
 13 and the City initiated the AB 506 process the next day. Montes Decl., ¶ 42 & Ex. R.

14 **B. The City Participated In The AB 506 Mediation Process In Good Faith, But**
 15 **Was Unable To Restructure Its Obligations**

16 Largely in response to the bankruptcy filing of Vallejo, California, in 2011 the California
 17 Legislature passed, and Governor Brown signed, Assembly Bill 506 (“AB 506”), codified at
 18 Government Code 53760 *et seq.* Before the passage of AB 506, California allowed its
 19 municipalities “the broadest possible” access to bankruptcy court, permitting cities to “file a
 20 petition and exercise powers pursuant to applicable federal bankruptcy law” without first
 21 satisfying any separate state-law requirements. Cal. Gov’t Code § 53760 (2008) (prior version of
 22 statute, repealed and replaced by AB 506); *see Int’l Bhd. of Elec. Workers, Local 2376, v. City of*
 23 *Vallejo, Cal. (In re City of Vallejo, Cal.),* 432 B.R. 262, 267 (E.D. Cal. 2010). AB 506 requires
 24 cash-strapped municipalities, before filing, either to participate in a “neutral evaluation process”
 25 for 60 to 90 days or to declare a “fiscal emergency” if the health and safety of the city’s residents
 26 would be compromised by waiting 60 or 90 days (the so-called “emergency off-ramp”). *See* Cal.
 27 Gov’t Code § 53760 (2012).

28 ///

1 The idea underlying the neutral evaluation process was that before filing, a municipality
2 should at least attempt to get all its creditors in a room, present the relevant financial information,
3 and attempt to negotiate a consensual, mutual restructuring of its debts outside of bankruptcy
4 court. *See generally* 2011 Cal. Stat. ch. 675, pp. 1-2. The primary goal was to avert a fiscal death
5 spiral and chapter 9 filing, which the legislature found “can have major short- and long-term
6 fiscal consequences for the municipality, the surrounding municipalities, and the state.” *Id.* It
7 further found that “[f]iling for bankruptcy protection under Chapter 9 should be considered a last
8 resort, to be instituted only after other reasonable efforts have been made to avoid a bankruptcy
9 filing or otherwise appropriately plan for it.” *Id.* Accordingly, the legislature found, “it is in the
10 interest of the state, local governments and the public that local government entities have
11 sufficiently sound financial capacity to provide required services to the public and meet their
12 contractual and other obligations during any restructuring or financial reorganization process.”
13 *Id.*

14 Following a public hearing on February 28, 2012, the City Council determined that the
15 City “is or likely will become unable to meet its financial obligations as and when those
16 obligations are due or become due and owing,” Cal. Gov’t Code § 53760.3, and voted to
17 commence the AB 506 process. Montes Decl., ¶ 43. The next day, the City transmitted by
18 certified mail to approximately 30 interested parties its “Notice of Initiation” of the process. *Id.*;
19 *see also* Cal. Gov’t Code § 53760.3(a). By March 15, 2012, nearly all of the potential interested
20 parties elected to participate in the mediation, including the City’s employee groups, its bond
21 trustee, bondholders, and all but one of its bond insurers. Montes Decl., ¶ 43; Cal. Gov’t Code §
22 53760.3(b). On March 26, 2012, the participants selected a “neutral evaluator,” or mediator, from
23 the list of five submitted by the City. Montes Decl., ¶ 44; Cal. Gov’t Code § 53760.3(c)(1). The
24 Honorable Ralph Mabey, a former bankruptcy judge and accomplished bankruptcy lawyer and
25 mediator, accepted the role the following day. Montes Decl., ¶ 44.

26 Beginning on March 27, 2012, the AB 506 process lasted 60 days, as mandated by statute.
27 Montes Decl., ¶ 44; Cal. Gov’t Code § 53760.3(r). On or around May 21, 2012, a majority of the
28 interested parties notified the City that the process would be extended by an additional 30 days.

1 Montes Decl., ¶ 44; Cal. Gov't Code § 53760.3(r). Despite good faith efforts by the City and the
2 interested parties, when the AB 506 process concluded on June 25, 2012, the City had not
3 “resolved all pending disputes with creditors.” Montes Decl., ¶ 46; Cal. Gov't Code § 53760.3.

4 As explained in greater detail below, the City is prepared to present extensive evidence
5 relating to its participation in the AB 506 process, including but not limited to: the number and
6 length of meetings between the City and its various creditors, the identity of the participants at
7 such meetings, the financial data and other information and the detailed 790-page “ask” the City
8 presented to all the interested parties, and the status of negotiations between the City and each
9 interested party as of the petition date. *See infra* Section III(B). However, California
10 Government Code section 53760.3(q) requires the parties not to “disclose statements made,
11 information disclosed, or document prepared or produced, during the neutral evaluation process”
12 *unless* disclosure of this information is “deemed necessary” by this Court “to determine
13 eligibility” for chapter 9 relief. The statute expressly contemplates that a municipality might need
14 to rely on evidence relating to the neutral evaluation, and the City believes that it cannot fully
15 prove its eligibility for chapter 9 under Bankruptcy Code sections 109(c)(2), 109(c)(5)(B),
16 109(c)(5)(C), and 921(c) without presenting such evidence to the Court. Accordingly,
17 concurrently with the filing of its chapter 9 petition, the City is filing separately an Emergency
18 Motion For Leave To Introduce Evidence Relating To Neutral Evaluation Under Government
19 Code Section 53760.3(q). The Emergency Motion demonstrates why the AB 506 evidence is
20 necessary to prove the City’s eligibility under the provisions cited above. Once granted, the City
21 will promptly file evidence concerning the AB 506 process.

22 **C. The City Filed Its Chapter 9 Petition**

23 The City’s General Fund financial projections for fiscal year 2012-13 show that the
24 General Fund will operate at a deficit of nearly \$26 million. From July 2012, the City will end
25 each month in fiscal year 2012-13 with a negative cash balance in the General Fund, ranging from
26 negative \$6.4 million in July 2012 to negative \$ 34.5 million in November 2012. Burke Decl., ¶
27 15. As these figures demonstrate, the City will lack sufficient funds in any month in fiscal year
28 2012-13 to permit the City to pay the General Fund obligations that it will incur. *Id.*

1 Recognizing this reality, and having exhausted efforts to secure and implement a workable budget
2 plan for the next fiscal year, the City concluded that chapter 9 protection was unavoidable.

3 On June 5, 2012, the City Council voted to authorize the City to file a petition for relief
4 under chapter 9 of the Bankruptcy Code in the event that the AB 506 process did not enable it to
5 avoid insolvency. Montes Decl., ¶ 46 & Ex. U. Following the conclusion of the AB 506 process
6 on June 25, and because the AB 506 process did not enable the City to achieve solvency in fiscal
7 year 2012-13, the City filed its chapter 9 petition on June 28, 2012.

8 **III. THE CITY IS AN ELIGIBLE DEBTOR UNDER CHAPTER 9 OF THE**
9 **BANKRUPTCY CODE**

10 To be eligible for relief under chapter 9, a petitioner must meet certain criteria. The Court
11 construes these criteria “broadly to provide access to relief in furtherance of the Code’s
12 underlying policies.” *Int’l Ass’n of Firefighters, Local 1186 v. City of Vallejo (In re City of*
13 *Vallejo)*, 408 B.R. 280, 288 (B.A.P. 9th Cir. 2009) (quoting *In re Valley Health Sys.*, 383 B.R.
14 156, 163 (Bankr. C.D. Cal. 2008)). Chapter 9 affords a municipality temporary protection from
15 debt collection efforts so that it may establish a plan of adjustment with its creditors. *Valley*
16 *Health*, 408 B.R. at 163.

17 11 U.S.C. § 109(c) provides that an entity is eligible to be a debtor under chapter 9 if it:

- 18 (1) is a municipality;
- 19 (2) is specifically authorized, in its capacity as a municipality or by
20 name, to be a debtor under such chapter by State law, or by a
21 governmental officer or organization empowered by State law to
22 authorize such entity to be a debtor under such chapter;
- 23 (3) is insolvent;
- 24 (4) desires to effect a plan to adjust such debts; and
- 25 (5)(A) has obtained the agreement of creditors holding at least a
26 majority in amount of the claims of each class that such entity
27 intends to impair under a plan in a case under such chapter;
- 28 (B) has negotiated in good faith with creditors and has failed to
obtain the agreement of creditors holding at least a majority in
amount of the claims of each class that such entity intends to impair
under a plan in a case under such chapter;

1 (C) is unable to negotiate with creditors because such negotiation is
2 impracticable; or

3 (D) reasonably believes that a creditor may attempt to obtain a
4 transfer that is avoidable under section 547 of title 11.

5 11 U.S.C. § 109(c). The City bears the burden of satisfying each criterion; if it cannot do so, the
6 Court should dismiss the City's petition. *Vallejo*, 408 B.R. at 289. As detailed below, Stockton
7 has carried this burden here, and is eligible to be a debtor under chapter 9.

8 **A. The City Is A Municipality.**

9 The petitioner under chapter 9 must be a municipality. *See* 11 U.S.C. § 109(c)(1). 11
10 U.S.C. § 101(40) defines a municipality as a "political subdivision or public agency or
11 instrumentality of a State." 11 U.S.C. § 101(40). The City is a political subdivision of the State
12 of California and is a municipality within the meaning of Section 109(c)(1). *See* Statement of
13 Qualifications Under 109(c).

14 **B. The City Is Authorized By California Law To Bring Its Petition.**

15 A chapter 9 petitioner must be specifically authorized under state law to be a debtor under
16 chapter 9 of the Bankruptcy Code. *See* 11 U.S.C. § 109(c)(2). As explained above, until last
17 year, California provided its municipalities "the broadest possible" access to bankruptcy court,
18 permitting cities to "file a petition and exercise powers pursuant to applicable federal bankruptcy
19 law" without first satisfying any separate state law requirements. *See Int'l Bhd. of Elec. Workers,*
20 *Local 2376 v. City of Vallejo (In re City of Vallejo)*, 432 B.R. 262, 268 (E.D. Cal. 2010) (quoting
21 Law Revision Commission Comments to Government Code section 53760). AB 506 amended
22 this historically broad grant to require that municipalities, prior to filing, either participate in a
23 "neutral evaluation process" or utilize the emergency off-ramp. *See* Cal. Gov't Code § 53760
24 (2012). While AB 506 imposes a new state law requirement, the Governor in his signing
25 message recognized that it did "not prevent a municipality from declaring bankruptcy or even
26 throw roadblocks in its path." *See* Historical and Statutory Notes to Government Code section
27 53760.

28 Assuming the Court grants the City's concurrent motion relating to the use of AB 506
evidence, the City will be able to demonstrate that it painstakingly and in good faith complied

1 with the statute’s requirements. Cal. Gov’t Code § 53760.1(d). At the conclusion of a public
2 meeting on February 28, 2012, the City Council determined that the City “is or likely will become
3 unable to meet its financial obligations as and when those obligations are due or become due and
4 owing,” *id.* § 53760.3, and voted to commence the AB 506 process. Montes Decl., ¶ 43. The
5 City identified “interested parties” as defined in the statute, *id.* § 53760.1(e). Montes Decl., ¶ 43.
6 It then transmitted to approximately 30 interested parties its “Notice of Initiation” of the process.
7 Cal. Gov’t Code § 53760.3(a); Montes Decl., ¶ 43. The interested parties responded. Cal. Gov’t
8 Code § 53760.3(b); Montes Decl., ¶ 43.

9 On March 26, 2012, the Participants (i.e., those interested parties that elected to
10 participate in the AB 506 process) selected a “neutral evaluator,” or mediator. Cal. Gov’t Code §
11 53760.3(c); Montes Decl., ¶ 44. The Honorable Ralph Mabey, a lawyer, law professor, and
12 former bankruptcy judge with extensive mediation experience, including in the Lehman Brothers
13 chapter 11 case pending in New York, accepted the position on March 27. Montes Decl., ¶ 44;
14 Cal. Gov’t Code § 53760.3(d). The mediation initially lasted for 60 days, but was extended
15 another 30 days by a vote by a majority of the Participants. Montes Decl., ¶ 44; Cal. Gov’t Code
16 § 53760.3(r). The neutral evaluation concluded on June 25, the 90th day following March 27,
17 without resolving all the City’s “pending disputes with creditors.” Cal. Gov’t Code § 53760.3(u);
18 Montes Decl., ¶ 46.

19 The City can prove that it (and others) participated in the AB 506 process in “good faith.”
20 Cal. Gov’t Code § 53760.3(o). The City also believes that the parties, by and large, maintained
21 the confidentiality required by the statute. *Id.* § 53760.3(q). It also can prove that it provided
22 sufficient information to the mediator and to the parties, including an extremely detailed, 790-
23 page, creditor-specific “ask” document. *Id.* § 53760.3(k). It will show that the City and the
24 Participants engaged in serious discussions—through many meetings and communications—
25 aimed at reaching a consensual restructuring of the City’s dramatically unbalanced finances.

26 All this is contingent on the Court allowing the City to present this evidence, as the statute
27 expressly contemplates the City doing. *See* Cal. Gov’t Code § 53760.3(q)(2). The City is
28 confident that once the Court reviews the activity that took place within the AB 506 process, it

1 will quickly conclude that the City in good faith completed the neutral evaluation and is
2 specifically authorized under state law to be a chapter 9 debtor.

3 **C. The City Is Insolvent Under Section 109(c)(3).**

4 The City's General Fund has operated at a deficit for four consecutive years. Absent the
5 City's massive (and sometimes unilateral) restructuring of labor costs, drastic cuts to General
6 Fund services and programs, and the actions taken by the City Council on February 28, 2012
7 (including deliberate but necessary default on the City's debt payments), the General Fund would
8 have run out of money long ago. It is insolvent now, and it will be insolvent in fiscal year 2012-
9 13. The gap this year is too large for cuts alone to close it. After years of struggle to keep the
10 City afloat, the day of reckoning has come. The City is broke; it needs relief from this Court.

11 **1. The Legal Standard**

12 A municipality is insolvent if it is not paying its bona fide debts as they come due or is
13 unable to do so. *Vallejo*, 408 B.R. at 289; *see* 11 U.S.C. § 101(32)(C)(i) and (ii). Insolvency is
14 determined based on the debtor's financial condition as of the date the petition is filed. *In re City*
15 *of Bridgeport*, 129 B.R. 332, 337 (D. Conn. 1991). Insolvency is primarily evaluated under a
16 cash flow analysis, as opposed to a balance sheet or budget deficit analysis. *Id.* at 337. However,
17 a municipality is not required to wait until it runs out of money and defaults on its debts before it
18 is deemed to be insolvent. Rather, whether a municipality will be unable to pay its debts when
19 due is a prospective analysis. *Id.* at 336. A municipality that demonstrates that it will be unable
20 to pay its debts in the next fiscal year is insolvent within the meaning of Section 101(32)(C) and
21 Section 109(c)(3). *Id.* at 338; *see also In re Pierce Cnty. Hous. Auth.*, 414 B.R. 702, 711 (Bankr.
22 W.D. Wash. 2009).

23 The insolvency analysis focuses on the General Fund. *Burke Decl.*, ¶ 7. Money in the
24 General Fund is unrestricted and supports public safety and other key municipal services. *Id.* As
25 the government's purse of last resort, it is also called upon to supplement and backfill shortages in
26 other programs. *Id.* By contrast, most of the City's funds are restricted by law, contract, or grant
27 and cannot be "pillaged" to subsidize the General Fund. *Vallejo*, 408 B.R. at 293; *Pierce County*,
28 414 B.R. at 711 ("Although the Debtor has substantial assets and cash reserves, it has very limited

1 funds and other assets that are not subject to a pre-existing limitation or restriction on their use.”).

2 The City is submitting a detailed analysis identifying which of its funds are unrestricted and

3 which are restricted, and identifying the legal source of restriction on each restricted fund. Burke

4 Decl., ¶ 8.

5 **2. The City Is Insolvent Now.**

6 The City is insolvent as of the date of its chapter 9 petition. Burke Decl., ¶ 10. The

7 actions adopted by the City Council on February 28, 2012 used up the last unrestricted reserves

8 from various funds available to the City, resulting in a projected June 30, 2012 available

9 unrestricted fund balance barely above zero. *Id.* While at first glance a positive balance suggests

10 solvency, the only reason the City will end the year with zero, rather than in a negative position,

11 is that the City failed to pay some of its legal obligations, including bond payments and separation

12 payments to retiring City employees. *Id.*; Montes Decl., ¶¶ 38-40. This was a desperation

13 measure to preserve operational liquidity. *Id.* And it resulted in legal action by an indenture

14 trustee and the City’s loss of possession of three parking garages and the 400 East Main Street

15 building that was to become the new City Hall. *Id.* ¶ 40.

16 These breaches preserved cash to provide the funding of the AB 506 process and to

17 continue vital operations through the end of the 2011-12 fiscal year. Burke Decl., ¶ 10; Montes

18 Decl. ¶ 37. But the City’s inability to meet its legally binding obligations demonstrates starkly

19 that the City is already insolvent in fiscal year 2011-12. Even in the current fiscal year, it has

20 reached a point where its budget gaps have simply become too large to address through cuts to

21 service and compensation, if essential services are to continue.⁵

22 **3. The City Will Be Insolvent in Fiscal Year 2012-13.**

23 As noted above, insolvency for chapter 9 purposes is determined under a prospective cash

24 flow analysis. *Bridgeport*, 129 B.R. at 337. The question is whether, as of the date the petition

25 was filed, the City “will be able to ‘pay its bills as they become due’” in the upcoming fiscal year.

26 *Id.* The answer to that question is unquestionably “no.”

27 ⁵ This path would not be sustainable in the long term. Continuing on the course set by February 28 would simply

28 leave the City “more debilitated tomorrow than it is today.” *Vallejo*, 408 B.R. at 293. “Effectively raiding funds for short-term needs would simply cripple” it more. *Id.*

1 An analysis of the City's July 2012 projected cash flow confirms that the City will not be
2 able to pay its debts as they become due as early as the first few days of July 2012. Burke Decl.,
3 ¶ 13. General Fund cash flow is sporadic. *Id.* While personnel expenses (68% of total expense)
4 are steady throughout the year, revenue receipts vary widely. *Id.* For example, the City receives
5 property tax revenues into the General Fund twice in a fiscal year, in December and April (with a
6 small settlement payment in June). *Id.* Other revenues may come into the General Fund on a
7 monthly basis (such as sales tax, and the utility users tax), quarterly (such as the transient
8 occupancy tax), or annual basis (such as business license tax or PG&E franchise payments), but
9 no substantial amount of revenues is received into the General Fund on a daily or weekly basis.
10 *Id.*

11 What General Fund obligations may come due in the first few days of the 2012-13 fiscal
12 year cannot be precisely projected. Burke Decl., ¶ 14. However, the City knows with certainty
13 that it must make a payroll payment on July 20, 2012, for the pay period ending on July 15, 2012.
14 *Id.* The amount of that General Fund payroll payment will be approximately \$4.9 million. *Id.*
15 The City will not have received General Fund revenues by July 20, 2012 sufficient to cover that
16 payroll payment. *Id.* ¶ 14. As just this one example shows, as a matter of fact and law, the City
17 is insolvent. *See Vallejo*, 408 B.R. at 288 ("in particular, Vallejo 'would not have been able to
18 pay the General Fund payroll that became due on July 11, 2008'"); *Bridgeport*, 129 B.R. at 337
19 (insufficient cash flow to pay bills when they are due establishes insolvency under chapter 9);
20 *compare id.* (despite a budget deficit, the city of Bridgeport was not insolvent because it began
21 the fiscal year with cash reserves of \$27 million, which would cover the deficit in every month).

22 Even assuming the City could cobble together the funds to make the July 20 payroll
23 payment, the City's cash flow analysis demonstrates that the General Fund will have a negative
24 ending balance in every month of fiscal year 2012-13, including a \$6.4 million negative ending
25 balance in July 2012, the first month of the fiscal year, up to a \$34.5 million negative ending
26 balance in November 2012. Burke Decl., ¶ 15. The source of the General Fund imbalance in
27 fiscal year 2012-13 is not a mystery. *Id.* ¶ 20. The trends from the last several years remain the
28 same: while City's revenues have not recovered following the steep decline during the recession,

1 its General Fund expenses remain the same or, in some cases, rise. *Id.* The City's General Fund
2 has no reserves. *Id.*

3 As the City has in fact already defaulted on some of its General Fund obligations, the law
4 does not require that the City wait until it actually runs out of money and defaults on all its
5 obligations before it is deemed insolvent and eligible for protection under chapter 9. *Bridgeport*,
6 129 B.R. at 336, 338. On the contrary:

7 Cities cannot go out of business. Chapter 9 is intended to enable a
8 financially distressed city to "continue to provide its residents with
9 essential services such as police protection, fire protection, sewage
10 and garbage removal, and schools . . . , while it works out a plan to
11 adjust its debts and obligations. A construction of [Section]
101(32)(C) under which a city would not be able to seek chapter 9
protection unless and until it was actually not paying its bills could
defeat that purpose, as actually not paying bills could lead to the
non-delivery of services.

12 *Bridgeport*, 129 B.R. at 336-37. Absent protection under chapter 9, the City will go out of
13 business almost immediately in fiscal year 2012-13 and will be unable to continue to provide
14 critical services to its residents.

15 Nor can the City borrow money from other City accounts or from the private credit
16 markets to temporarily cover its July 20, 2012 payroll obligation or any other cash flow deficit it
17 will encounter in fiscal year 2012-13. Burke Decl., ¶ 16. First, the City is not creditworthy, and
18 private credit markets would not give the City a loan when the City has no General Fund reserves
19 and its financial projections demonstrate the inability to repay the loan. *Id.*; *In re McCurtain*
20 *Mun. Auth.*, No. 07-80363, 2007 WL 4287604, *6 (Bankr. E.D. Okla. Dec. 4, 2007). Second,
21 there is not enough money lawfully available in other City accounts to cover the large cash flow
22 shortfalls that Stockton will experience in fiscal year 2012-13. Burke Decl., ¶ 16. Almost all of
23 the money in the City's other funds is restricted by law for use in connection with the programs or
24 services for which the funds were established. *Id.*

25 Regardless, Stockton cannot lawfully borrow from other City funds (or the private market)
26 because the City cannot demonstrate the ability to pay back any such loan with revenues
27 generated in fiscal year 2012-13, as the law requires. Burke Decl., ¶ 17. Article XVI, Section 18
28 of the California Constitution prohibits the City from incurring a debt in any year that exceeds the

1 available revenues of the City for that year, without the approval of two-thirds of the qualified
 2 voters. Cal. Const., art. XVI, § 18. In plain terms, each year's City revenue must pay each year's
 3 City expenditures. *See, e.g., Barkley v. City of Blue Lake*, 47 Cal. App. 4th 309, 313 (1996)
 4 (Section 18 "construed to require each year's debts and liabilities to be paid from that year's
 5 revenues, and to bar payment from the revenue of any future year"). Given that the City projects
 6 a \$26 million deficit for fiscal year 2012-13 and has no General Fund reserves, a loan to the
 7 General Fund from another City fund or a private creditor would necessarily create a debt that
 8 exceeded the City's available revenue for the fiscal year in violation of Article XVI, Section 18.
 9 *Burke Decl.*, ¶ 17. It also would violate restrictions placed on those other City funds (such as gas
 10 tax, grants, developer fees, water and sewer utility fees) by expending them for purposes not
 11 allowed by state or federal law. *Id.*

12 In sum, the City's financial projections starkly demonstrate that the City lacks the General
 13 Fund revenues and reserves to provide the cash flow necessary to pay the City's debts as they
 14 become due in fiscal year 2012-13. *Burke Decl.*, ¶ 13. Within the first few days of the fiscal
 15 year, the City will be in a negative cash flow situation from which it will not emerge during the
 16 rest of the year (or for each subsequent fiscal year analyzed). *Id.* Pursuant to Section 101(32)(C),
 17 the City is insolvent within the meaning of Section 109(c)(3) and, accordingly, is eligible to file a
 18 chapter 9 petition. *See Bridgeport*, 129 B.R. at 337.

19 **4. The City's Fiscal Year 2012-13 Financial Projections Confirm That**
 20 **the City Will Not Be Able to Pay Its Debts When Due.**

21 The City's inability to pay its debts when due in fiscal year 2012-13 results from the lack
 22 of General Fund reserves and the substantial General Fund deficit the City projects for fiscal year
 23 2012-13. Because it is the City's burden to prove that it is insolvent, the City discusses in some
 24 detail its projected General Fund revenues and expenditures for fiscal year 2012-13. *See*
 25 *Bridgeport*, 129 B.R. at 334.

26 **a. Fiscal Year 2012-13 Revenues**

27 The City projects that General Fund revenues in fiscal year 2012-13 will be approximately
 28 \$154.9 million. *Burke Decl.*, ¶ 22. Adverse economic conditions continue to affect the City's

1 primary revenue sources: property taxes, sales taxes, utility user taxes, franchise taxes, and
2 business license taxes, which combined account for about 86% of General Fund revenue. *Id.*

3 ***Property taxes.*** The City estimates a 4.9% decline in property taxes from fiscal year
4 2011-12 to fiscal year 2012-13. Burke Decl., ¶ 23. This estimate is based on information
5 provided to the City by its tax auditor, HdL, and in part on communications with the San Joaquin
6 County Assessor, local banks, and local developers. *Id.* A major factor depressing property taxes
7 is the structure of California's property tax system. Burke Decl., ¶ 24. It is unusual in that annual
8 assessed value adjustments, absent a change in ownership or new construction on the property,
9 are limited to the lesser of the change in the California consumer price index or two percent. *Id.*
10 An increase or decrease in the assessed value does occur upon a change in property ownership,
11 and new construction is assessed at a value established by the assessor. *Id.* Where changes in
12 ownership result in a lower assessed value (which is typically the case in foreclosures and short or
13 distressed sales), the new base is locked in at the lower value and can only increase at the lesser
14 of the CPI or two percent per year. *Id.* Thus, the high rate of foreclosures and short or distressed
15 sales in Stockton will penalize the City for years to come with lower property tax revenues and
16 growth rates compared to cities with lower numbers of such transactions. *Id.*

17 ***Sales and use taxes.*** HdL estimates that fiscal year 2012-13 sales taxes will continue a
18 modest upward trend, but revenues still lag 17% below the peak revenue year of 2005-06. Burke
19 Decl., ¶ 25.

20 ***Utility Users Tax ("UUT"), Franchise Tax, and Business License Tax.*** The UUT and
21 franchise tax depend on resident use, while the business license tax depends on economic activity.
22 Given the City's still-depressed economic environment, the City projects that these revenue
23 streams will remain flat in the upcoming fiscal year. Burke Decl., ¶ 26.

24 As these numbers demonstrate, after periods of sharp decline, the City's annual revenues
25 are, at best, slowing in their rate of decline; overall, General Fund revenues for fiscal year 2012-
26 13 are projected to drop 2% from 2011-12. Burke Decl., ¶ 22. There is no easy fix for the City's
27 revenue situation. Both the California Constitution and the City Charter require the City to have a
28 balanced budget at the beginning of each fiscal year.

1 Legal and accounting requirements also limit the City's ability to raise or borrow money
2 to close revenue shortfalls. Burke Decl., ¶ 27. Proposition 13 limits property tax rates to 1% of
3 fair market value, subject to the limitations described above, exclusive of voter-approved bonded
4 indebtedness. Cal. Const., art. XIII A. Proposition 218, passed by the voters in 1996, limits the
5 City's ability to raise any other taxes by requiring that a majority of voters approve any new or
6 increased general tax (one the proceeds of which can be used for any purpose) and that a two-
7 thirds majority approve any new or increased special tax (one expressly limited to a specific
8 purpose). Cal. Const., arts. XIII C and XIII D. Further, Proposition 218 places significant
9 restrictions on the ability of the City to raise special assessments or property related fees to cover
10 specific costs, and in any event, these types of revenues are not permitted to be used for general
11 governmental purposes such as those funded from the City's General Fund. Cal. Const. Art.
12 XIII D. Locally, voters' enactment of Measures K (a half-cent sales tax for transportation enacted
13 in 1990) and W (a quarter-cent sales tax for public safety enacted in 2004) established and
14 dedicated supplemental sales taxes to specified programs, leaving the City with limited
15 opportunities to create new general purpose revenue sources. Burke Decl., ¶ 28. As
16 demonstrated above, the City cannot borrow the funds to make up a cash flow or revenue shortfall
17 either because it cannot pay back a loan with unrestricted revenues attributable to fiscal year
18 2012-13, as required by the California Constitution.

19 Obtaining voter approval for new taxes or borrowing is highly speculative under normal
20 circumstances. Burke Decl., ¶ 29. It is even more uncertain given the City's historically high
21 rates of foreclosures and unemployment and public concern over the City's past practices,
22 including in establishing an overly generous retiree health program and incurring debt it now
23 cannot afford to pay. *Id.* Even where the City can lawfully raise revenue with voter approval, the
24 reality is that the voters of the City are extremely unlikely to impose higher taxes on themselves,
25 particularly in the current economic climate. *Id.* While the City intends to pursue all potentially
26 viable methods of generating new revenues, history shows that raising taxes is not necessarily a
27 realistic tool in solving local agency fiscal problems. *See, e.g., Cal. Bldg. Indus. Ass'n v.*
28 *Governing Bd.*, 206 Cal. App. 3d 212, 236-37 (1988) (intent of the supermajority requirement

1 under Proposition 13 is that voters are often not willing to impose taxes on themselves); *Candid*
 2 *Enters. v. Grossmont Union High Sch. Dist.*, 39 Cal. 3d 878, 882 (1985) (“Although Proposition
 3 13 authorizes the imposition of ‘special taxes’ by a vote of two-thirds of the electorate, such
 4 special taxes have rarely been imposed, remain novel, and as a consequence are evidently not
 5 perceived as a practical method of school facility financing -- especially in view of the need for a
 6 two-thirds vote of the electorate to approve them.”).

7 Nor are other sources of potential revenue viable. For example, the City has analyzed
 8 whether any nonessential real property it owns might be sold to raise (one-time) revenue.
 9 Declaration of Michael Locke, ¶ 3. While the City has not yet completed its analysis, preliminary
 10 results indicate that what property the City holds, if sold, would not yield any more than a few
 11 hundred thousand dollars as a one-time contribution to the General Fund. *Id.* ¶¶ 5-6.

12 The City has spent two years exhausting every possible revenue source. Burke Decl., ¶
 13 30. The City hired Management Partners to check the findings of its staff in early 2012 and those
 14 findings were confirmed. Montes Decl., ¶ 34 & Ex. P. This spring, a team of 10 independent
 15 Certified Public Accountants has been auditing the City’s fiscal 2010-11 records. Burke Decl., ¶
 16 30. Such review is consistent with the City Council’s objective of putting the City’s “Fiscal
 17 House In Order,” looks forward to the auditors’ findings. *Id.* Preliminary results of the audit,
 18 however, have not resulted in findings that would materially increase unrestricted fund balances.
 19 *Id.*

20 **b. Fiscal Year 2012-13 Expenditures**

21 The City projects expenditures for fiscal year 2012-13 to be \$180.8 million. Burke Decl.,
 22 ¶ 31. This figure is dependent on certain assumptions. *Id.* ¶ 32. First and foremost, it assumes
 23 that a court will not rule against the City in the pending litigation over compensation and benefit
 24 reductions imposed by the City on some of its employees. Goodrich Decl., ¶¶ 10-12. As noted
 25 earlier, were this to occur, the General Fund would be liable for at least another approximately
 26 \$12.5 million immediately, a judgment not accounted for in its budget and which would
 27 immediately plunge the City into deeper insolvency. Further, the budget assumes that upcoming
 28 pay and benefit increases under current CBAs will not be granted, and that previous impositions

1 remain in effect. This represents an additional \$9.2 million in General Fund cost through the end
 2 of the CBAs that extend to mid-2014. In addition, as noted above, the City defaulted on three of
 3 its General Fund bond obligations during fiscal year 2011-2012. Claims have been made by the
 4 bond trustee for these bond issues and if those claims are pursued in court, the City will be liable
 5 to repay over \$2,000,000 to the bond trustee plus very substantial legal fees and costs that the
 6 bond trustee already has alleged exceed \$1,000,000.

7 The following is an approximate allocation of the City's projected 2012-13 General Fund
 8 expenditures, totaling \$180.8 million:

- 9 • \$91.2 million (50.4% of total) for base salary, current employee health care, and
 10 other personnel costs (including overtime, workers compensation, "add" pays, and
 11 compensated absences), an increase of 6.7% over fiscal year 2011-12;
- 12 • \$16.6 million (9.2%) for pension funding with CalPERS, an increase of 3.3%;
- 13 • \$9.2 million (5.1%) for retiree health care, an increase of 15.3%;
- 14 • \$12.3 million (6.8%) for debt service (including on pension obligation bonds), an
 15 increase of 23.8%;
- 16 • \$15.9 million (8.8%) for program support required by library, recreation, golf,
 17 entertainment venues and redevelopment successor agency, an increase of 20.4%;
- 18 • \$33.6 million (18.6%) for services and supplies, an increase of 1.4%; and
- 19 • \$2.0 million (1.1%) for contingency.

20 Burke Decl., ¶ 34. As explained below, none of the City's major expense categories are projected
 21 to decrease in the fiscal year, and in aggregate expenditures are projected to *increase* 8.0%.

22 (1) The City's Labor Costs

23 As noted above, labor costs—in particular, police officers and firefighters—continue to
 24 contribute the vast majority of the General Fund expenditures. Burke Decl., ¶ 36. Altogether, the
 25 Police and Fire departments comprise 91% of personnel costs paid by the General Fund (and
 26 approximately 70% of all General Fund expenditures), including grant-funded positions the
 27 General Fund must support when the grants expire. *Id.* ¶ 36. Under the continuing fiscal
 28 emergency, the City has drastically reduced labor costs by renegotiating contracts, imposing

1 unilateral alterations to the terms of individual CBAs, and by slashing the number of funded
 2 positions. *Id.* ¶ 37. The increase in salaries from fiscal year 2012-13 is largely due to absorbing
 3 police personnel that were previously paid by grants (\$2.9 million) and phasing out half of
 4 furlough savings to address workload issues (\$1.1 million). *Id.* There is no change in staffing
 5 levels. *Id.*

6 Seven of the City's nine CBAs, including those with the police and fire unions, will expire
 7 on June 30, 2012. Goodrich Decl., ¶ 13. As reflected in the Pendency Plan adopted by the City
 8 Council on June 26, 2012, the City intends to obtain significant savings both through the
 9 continued exercise of its fiscal emergency powers and through the imposition of new terms and
 10 conditions of employment, should the parties be unable to reach agreement. Goodrich Decl., ¶
 11 13; Burke Decl., ¶ 38. Given the magnitude of past cuts, though, the City cannot eliminate any
 12 more police or firefighter positions without further endangering public safety. Jones Decl., ¶¶ 9-
 13 14; Montes Decl., ¶ 48. It also cannot close its budget gap on labor cuts alone. Jones Decl., ¶ 15;
 14 Montes Decl., ¶ 49. Reducing total compensation and benefits to below market rates could hasten
 15 the departure of employees, who would be difficult to replace with equally skilled applicants.
 16 This is particularly true for departments like Police, for whose recruits Stockton likely is
 17 considered a less desirable situation than many other jurisdictions. Jones Decl., ¶ 15.

18 (2) CalPERS Pension Costs

19 CalPERS costs are driven by the state's actuarial report and the discount rate that
 20 CalPERS uses for investment earnings. Burke Decl., ¶ 39. Future risks include additional
 21 reductions in the discount rate and/or CalPERS investment losses, starting in fiscal year 2013-14.
 22 *Id.* But in the short term, for the fiscal year 2012-13 insolvency analysis, CalPERS costs are set
 23 by formula and state law. *Id.*

24 (3) The City's Debt Service

25 The City's debt service expenditures have been and will continue to trend upward. Burke
 26 Decl., ¶ 40. The City administers approximately 50 bond issues and lease financing
 27 arrangements. *Id.* Seven of these bond issues are backed by the General Fund. *Id.* Though a
 28

1 relatively small percentage of General Fund expenditures, debt payments serve as a useful
2 example of the sort of decision-making (and bad luck) that plunged the City into insolvency.

3 Over the last decade, the City incurred large amounts of debt in connection with an
4 ambitious urban renewal plan. Burke Decl., ¶ 41; see Erin Hallissy, *Mudville Takes a Mighty*
5 *Swing at Glory*, S.F. CHRON., Apr. 28, 2005, at A1 (“more than \$500 million is being spent to
6 renovate or completely remake more than 75 city blocks”); Sam Quinones, *A Cutting-Edge City:*
7 *Stockton?*, L.A. TIMES, June 25, 2006, at B1 (“Stockton has bet \$126 million on what officials
8 believe is California’s largest redevelopment project.”). Among the obligations the City incurred
9 were \$46 million to construct the events center/arena (through the 2004 Arena Project lease
10 revenue bonds), \$32 million for two parking garages and other capital projects (2004 Lease
11 Revenue Bonds), \$40 million for a new City Hall (2007 Lease Revenue Bonds), \$13.5 million for
12 the Essential Services Building (completed in 2001 and refinanced by 2006 Lease Revenue
13 Bonds), \$35 million for a fire station, police communications center, parks, and street
14 improvements (2009 Lease Revenue Bonds), \$13 million for housing projects (2003 Certificates
15 of Participation), and \$11 million for marina construction (2006 Dept. of Boating & Waterways
16 loan). Burke Decl., ¶ 42.

17 Underlying this growth strategy seems to have been the assumption that the explosive
18 growth occurring in the housing sector would continue indefinitely, and that developer fees and
19 property tax growth would provide sufficient revenue to meet these obligations. Burke Decl., ¶
20 43. The City thus “back-loaded” some debt payment schedules to increase annual debt payments
21 over time. *Id.* Moreover, in order to finance its new facilities, the City agreed to use the General
22 Fund as backup security for bond repayment, even where other payment streams were available.
23 *Id.*

24 Likewise, in 2007, the City took on \$125 million of pension obligation bonds in an effort
25 to pay off an unfunded liability at a lower cost than PERS actuarial rates. Burke Decl., ¶ 44. But
26 it placed these funds into CalPERS at the height of the boom, right before CalPERS sustained
27 huge portfolio losses. *Id.* Effectively, this meant that the City was still required to pay the same
28 amount of interest to bondholders, but the principal amount that was being invested by CalPERS

1 instead *declined* by approximately 30%, reinstating a comparable amount of unfunded liability.

2 *Id.* As of June 30, 2010, the City had a combined unfunded actuarial liability for its safety and
3 miscellaneous employee benefits plans of \$148.5 million to make up on a going-forward basis.

4 *Id.*

5 Finally, in the midst of an economic downturn, the City incurred additional risk by issuing
6 variable rate bonds to finance the purchase of an office building located at 400 East Main Street.

7 Burke Decl., ¶ 45. The City counted on significant rental income from such property, but instead
8 the building failed to generate sufficient income to pay the bond debt, forcing the City to default
9 on the debt on May 1, 2012.⁶ *Id.*; *Wells Fargo Bank, N.A. v. City of Stockton*, No. 39-2012-
10 00280741 (San Joaquin Super. Ct. May 10, 2012).

11 As a result of all these decisions, the General Fund is carrying approximately \$316 million
12 in total outstanding indebtedness, including from some situations where it is backfilling
13 obligations that could have been made payable by other funds, but for their lack of resources to
14 do so. Burke Decl., ¶ 46. In recent years, maximum debt service exposure has increased nearly
15 sixfold, from \$3 million in fiscal year 2006-07 to \$17.7 million in fiscal year 2012-13. *Id.*

16 (4) The City's Retiree Medical Costs

17 Though projected only to absorb 5.1% of the fiscal year 2012-13 General Fund
18 expenditures, retiree medical costs also are trending upward and represent a significant future
19 financial risk. In fact, due to the combination of growth in the number of retirees receiving
20 benefits and medical inflation, the City's costs for retiree medical are expected to double in the
21 next 10 years.

22 In the 1990s, the City greatly expanded its retiree health insurance commitments to levels
23 well beyond what other cities offered. Declaration of Teresia Haase, ¶ 4 & Ex. A. By and large,
24 the benefits were uncapped. *Id.* More worryingly, the City instituted no minimum service

25 _____
26 ⁶ Variable rates for municipal bonds have generally remained low in the market, but the liquidity provider for the
27 City's 2007 Bonds is Dexia Credit Local, the U.S. branch of an embattled French bank, that experienced significant
28 financial difficulties of its own over the past two years. As a result, investors demanded interest rates of up to 8 times
the market rate for the City's 2007 Bonds (over 4% instead of approximately 0.5%, before payment of liquidity and
remarketing fees), and since the actions taken by the City on February 28, 2012 described above, virtually all of these
bonds have been tendered to Dexia, resulting in their interest rate increasing to the default rate of 6.25%.

1 requirements. *Id.* An employee could work in Stockton *for a few months* and obtain uncapped
 2 health benefits for the rest of his or her life. *Id.* Moreover, the 1,100 of Stockton's 2,400 retirees
 3 who receive this benefit are the most recent retirees. *Id.* ¶ 5 & Ex. A. They retired after the City
 4 added retirement enhancements in the late 1990s and early 2000s that increased the pensions of
 5 existing employees. *Id.* Therefore, the average pension received by retirees without medical
 6 benefits is \$24,029. *Id.* The average pension for retirees *with* medical benefits is \$50,687 a year.
 7 *Id.*

8 The glaring problem with this generous perk was that the City did not fund it on an
 9 actuarially sound basis. Haase Decl., ¶ 6 & Ex. A. In the upcoming fiscal year, pay-as-you-go
 10 retiree medical costs for all funds will total approximately \$16.7 million (of which \$9.2 million is
 11 attributable to the General Fund). Haase Decl., ¶ 6; Burke Decl., ¶ 47. This amount is projected
 12 to double in ten years. Haase Decl., Ex. A; Burke Decl., ¶ 47. According to the City's outside
 13 actuaries, to adequately prefund its obligations and current obligations, the City should be
 14 spending nearly *double* what it has budgeted for retiree health. Haase Decl., ¶ 7. For fiscal year
 15 2012-13, this works out to approximately \$31 million, or 30% of the City's payroll. *Id.* By
 16 comparison with 16 comparable jurisdictions, some have no retiree benefits at all, several others
 17 only provide benefits (such as contributions to health savings accounts) to active employees, and
 18 of those that provide ongoing benefits to retirees, none has retiree medical obligations much
 19 greater than 15% of payroll. *Id.* Over time, this outsized and chronically underfunded liability
 20 represents a significant risk to the City's continued viability. *Id.* (identifying an unfunded \$417
 21 million liability).

22 (5) Services and Supplies

23 This category comprises the bulk of non-personnel costs, and increases are primarily
 24 inflationary in nature. Burke Decl., ¶ 48.

25 (6) Program Support

26 This category includes support of non-General Fund programs that lack the resources to
 27 meet existing obligations. Burke Decl., ¶ 49. This includes the library, recreation programs, golf
 28 courses, entertainment venue and sports team subsidies, and support of the wind-down of the

1 redevelopment agency. *Id.* Increases are chiefly attributable to planned fiscal stabilization
 2 expenses—amounts needed to ensure the City does not fall further behind, and is sustainable over
 3 time. *Id.* These include \$2 million for increased preventative maintenance and \$800,000 to
 4 reduce deficits in the workers compensation and self-insurance fund. *Id.*

5 **5. Further Cuts Would Endanger the Welfare and Safety of the City's**
 6 **Residents and Businesses.**

7 During the past four years, in response to the declining economy, Stockton has out of
 8 necessity reduced or eliminated funding for almost all General Fund programs and services below
 9 levels that the City views as minimally acceptable. Little is left to cut in these areas, and what
 10 reductions could be made are not nearly enough to even approach solving the City's financial
 11 difficulties. The City is not only already cash-insolvent. It is service-insolvent as well.

12 Public safety is in a state of crisis in the City. Jones Decl., ¶¶ 3-11. Violent crime is
 13 rising, murders are at an all-time high, and gang and drug activity is increasing. *Id.* Further cuts
 14 to police protection would imperil the City's residents. *Id.* ¶¶ 12-15. Police would be able to
 15 respond only to the most serious violent crimes in progress, and even that response might be
 16 delayed. *Id.* Investigating crimes would take longer. *Id.* Special units would be eliminated, as
 17 would Animal Services and Graffiti abatement. *Id.*

18 As for non-safety positions, the City already has eliminated significant resources—almost
 19 half of General Fund non-safety positions—that otherwise would be devoted to maintenance and
 20 repair. Montes Decl., ¶¶ 29-31. Many vehicles are beyond their useful life now. *Id.* More
 21 would reach this point, endangering staff and citizens. *Id.* ¶ 49. City buildings, roads, trees, and
 22 parks, which have begun to be neglected, would deteriorate further. *Id.*

23 To prove insolvency, the City need not prove that it has cut every possible service.
 24 *Vallejo*, 408 B.R. at 294. Even where additional cuts are theoretically possible, the City need not
 25 attempt them if “municipal services [are already] underfunded” and further reductions would
 26 threaten the City's ability to provide for the basic health and safety of its citizens. *Id.*

27 Sadly, the City easily meets this test. The hard reality is that after multiple rounds of
 28 reductions, there are no more positions to cut and not enough wage concessions to obtain for the

1 City to continue to balance its budget on these strategies. Municipal services are severely
 2 underfunded now, and further reductions would threaten the health and safety of the City's
 3 residents.

4 **6. The City Has Adopted a Pendency Plan Contingent on Obtaining**
 5 **Relief in This Court.**

6 On June 26, 2012, the City Council adopted a "Pendency Plan" budget based on the
 7 assumption that the City would file this petition before the beginning of fiscal year 2012-13.
 8 Burke Decl., ¶ 50. The Pendency Plan provided for a balanced budget in fiscal year 2012-13, but
 9 *only* by using measures that, outside of bankruptcy, would otherwise violate state law or the
 10 City's contractual obligations. *Id.* Thus, while the Pendency Plan provides a prospective path for
 11 the City to follow in its anticipated bankruptcy case, its adoption does not take away from the fact
 12 that, absent chapter 9 relief, the City is insolvent now and will be insolvent in fiscal year 2012-13.

13 **D. The City Desires To Effect A Plan To Adjust Its Debts.**

14 No bright-line test exists for determining whether a debtor desires to effect a plan because
 15 of the highly subjective nature of the inquiry under 109(c)(4). *Vallejo*, 408 B.R. at 295. The
 16 petitioner "may satisfy this subjective requirement with direct and circumstantial evidence," *id.*,
 17 sufficient to show that the "purpose of the filing of the chapter 9 petition not simply be to buy
 18 time or to evade creditors," *id.* (internal citations omitted).

19 After three years of brutal budget-balancing producing \$90 million of savings and
 20 reduction levels perhaps seen nowhere else in the state (except in the City of Vallejo's chapter 9
 21 case), by early 2012 it became clear to the City that it had no other option but to initiate the AB
 22 506 process and, if that was not successful, to adjust its debts in a bankruptcy case. *See supra*
 23 Section II(A)(3). This assessment was confirmed by an independent report prepared by outside
 24 experts. *Id.* On February 28, the City Manager frankly discussed with the City Council the need
 25 to consider a "financial restructuring" that would "result in sustainable and healthy enterprise[]
 26 going forward." Montes Decl., ¶ 35 & Ex. Q at 3. Agreeing that such a step was necessary, the
 27 City Council voted to initiate the AB 506 process. Montes Decl., ¶ 37.

28 ///

1 The City’s good-faith participation in the AB 506 process is itself powerful evidence of its
 2 intent to effect a plan. One goal of the AB 506 process is that the parties “reach a settlement and
 3 avoid[] a bankruptcy filing” or “otherwise lead to a prenegotiated consensual plan of readjustment
 4 [sic].” Consistent with this directive, the City prepared a 790-page “ask” which contained
 5 specific proposals relating to each Participant and to other parties that chose not to participate.
 6 Montes Decl., ¶ 45. The ask was similar to a plan of adjustment in that it disclosed to all
 7 creditors how the City viewed the claims of each and what each might expect in a plan of
 8 adjustment. *Id.* Using the ask as a baseline and providing relevant financial information, the City
 9 then actively negotiated with its creditors. *Id.* Though it was unable to obtain a global settlement
 10 within the 90 days provided, the City and its creditors benefitted greatly from the City’s
 11 compiling of the metrics of a de facto draft plan of adjustment that described to all major creditors
 12 the treatment of the individual claims.

13 With a cash crunch approaching at the beginning of the fiscal year, like in *Vallejo*, here
 14 the City “filed its petition not to buy time, but because it ran out of time.” 408 B.R. at 295. After
 15 the completion of the AB 506 process and “as of the petition date,” Stockton “had exhausted all
 16 other avenues.” *Vallejo*, 408 B.R. at 295. Its City Manager certified as such, a factor which the
 17 *Vallejo* court found relevant. *See* Statement Of Qualifications; *Vallejo*, 408 B.R. at 295. And its
 18 good faith drafting of the ask, along with its recent adoption of the Pendency Plan, demonstrates
 19 that its petition is “designed to result in an eventual plan of adjustment of debts.” *Vallejo*, 408
 20 B.R. at 295 (finding the adoption of a Pendency Plan indicative of Vallejo’s intent to effect a
 21 plan).

22 **E. The City Has Met The Negotiation Requirement Under Section 109(c)(5).**

23 Section 109(c)(5) provides four alternative tests for proving that the City attempted to
 24 negotiate with its creditors before filing its petition. The City need satisfy only one of the four to
 25 be found eligible for chapter 9 relief. Here, the City will demonstrate that it “negotiated in good
 26 faith with creditors and has failed to obtain the agreement of creditors holding at least a majority
 27 in amount of the claims of each class that [it] intends to impair under a plan.”

28 ///

1 11 U.S.C. § 109(c)(5)(B). Alternatively, the City was “unable to negotiate with creditors because
2 such negotiation is impracticable.” 11 U.S.C. § 109(c)(5)(C).

3 **1. The City Satisfied the Good Faith Negotiation Standard Set Forth in**
4 **Section 109(c)(5)(B).**

5 Subsection (B) requires that the City demonstrate that it has “negotiated in good faith with
6 creditors and has failed to obtain the agreement of creditors holding at least a majority in amount
7 of the claims of each class that [it] intends to impair under a plan.” While these negotiations need
8 not revolve around a “complete plan,” “some outline or term sheet of a plan which designates
9 classes of creditors and their treatment is necessary.” *Vallejo*, 408 B.R. at 297.

10 Like in *Vallejo*, here the City has been in a near-constant state of negotiations with its
11 labor unions for multiple years, as it sought to balance each year’s budget with a combination of
12 voluntary and involuntary compensation and benefits reductions. Goodrich Decl., ¶¶ 6-11;
13 Montes Decl., ¶¶ 17-31. These negotiations have been essential to keeping the City afloat the last
14 few years and laid the groundwork for the AB 506 process.

15 More than that, and unlike in *Vallejo*, through the AB 506 process the City recently
16 engaged most of its major creditors in a way that revolved around their treatment under a
17 potential plan. Montes Decl., ¶¶ 43-36. By design, the AB 506 process brought together the City
18 and most of its largest creditors. *Id.* These included employee groups, a group representing some
19 retirees, most of the City’s capital markets creditors, and other creditors with significant
20 obligations as a result of contracts or litigation, i.e., the very parties that would be categorized
21 into classes under any plan of adjustment. *Id.* As the City will demonstrate after the Court allows
22 in the relevant evidence, the City spent enormous time and resources developing its ask to each
23 interested party/future plan class. The intent of the City was the same as if it had been drafting a
24 plan of adjustment: to restructure its obligations in a way to achieve solvency while treating
25 creditors equitably. In this way, the City’s presentation of the ask, and subsequent negotiations
26 based on the ask, gave its creditors advance notice of their treatment under a plan of adjustment.
27 The *Vallejo* court anticipated exactly this sort of “proposed plan” “in concept,” and the City has
28 satisfied subsection (c)(5)(B).

1 2. **Alternatively, the City Was Unable to Negotiate With Its Creditors**
2 **Because Such Negotiation Was Impracticable.**

3 As an alternative basis for satisfying § 109(c)(5)'s requirements, the City was unable to
4 negotiate with its creditors because such negotiation was impracticable. *See* 11 U.S.C. §
5 109(c)(5)(C). While in good faith the City negotiated with many of its creditors concerning the
6 terms of a proposed plan, it was unlikely to achieve a successful restructuring because (1) the
7 number of parties competing for too few dollars made it highly unlikely that a global restructuring
8 plan would be achieved in a voluntary setting; and (2) it could not bind its numerous retirees to
9 any deal negotiated in the AB 506 process.

10 The definition of “impracticable” is broad. *Vallejo*, 408 B.R. at 298. Petitioners may
11 demonstrate impracticability by the sheer number of their creditors. *Id.*; *see In re New York City*
12 *Off-Track Betting Corp.*, 427 B.R. 256, 276 (Bankr. S.D.N.Y. 2010) (“Courts frequently find that
13 negotiations are impracticable where debtors have large numbers of creditors”). They may also
14 show impracticability by their need to file a petition quickly to preserve their assets or to act
15 quickly to protect the public from harm. *Id.* These examples are illustrative, not exclusive. *Id.*;
16 *see also Valley Health*, 383 B.R. at 163 (“impracticability” requirement did not require the debtor
17 to either engage in good faith pre-petition negotiations with its creditors to an impasse or to
18 satisfy a numerosity requirement before determining that negotiation is impracticable).

19 Thus, in *Vallejo* the court found negotiations with creditors impracticable where the City
20 could not effectively identify all of its retirees, potential tort claimants, and other creditors.
21 *Vallejo*, 408 B.R. at 298. The court in *Valley Health* likewise found negotiation impracticable
22 where the City sent out notice of the case to 2,775 creditors and parties in interest, and claims
23 totaled \$100 million. *Valley Health*, 383 B.R. at 165. Similarly, in *Pierce County*, negotiation
24 was impracticable where the City had thousands of potential creditors. *Pierce County*, 414 B.R.
25 at 713.

26 The City has more than 5,000 creditors and parties in interest and potential claims totaling
27 more than \$500 million against the General Fund. *See* Creditor List. Looking beyond the raw
28 numbers, despite Judge Mabey’s, the City’s, and the Participants’ hard work in the AB 506

1 process, it was unlikely that the City would reach agreements with all of its creditors and be able
 2 to avert the impending cash crunch in fiscal year 2012-13. As noted above, the City has nine
 3 separate employee groups, each with its own interests to protect. Goodrich Decl., ¶ 3. It also has
 4 an indenture trustee and numerous bondholder and bond insurer creditors for the massive amount
 5 of outstanding debt it owes. Burke Decl., ¶ 46. Again, each of these individual parties has its
 6 own interests, which often conflict with the interests of other creditors. Bringing every single
 7 party into one global agreement, even if ultimately possible, was highly unlikely. *See, e.g., OTB*,
 8 427 B.R. at 278 (“While some of these creditors may yield . . . others may not”). Delaying the
 9 filing of its chapter 9 petition, and thus being forced to close its budget gap by draconian service
 10 cuts, would have jeopardized the health and safety of the City’s residents. *See supra* Section
 11 III(C)(5).

12 Second, in the unlikely occurrence that the City was able to reach agreement with all of its
 13 employee groups and all of financial creditors, reaching a global agreement was still
 14 impracticable because the City had no mechanism to bind its retirees. As explained above, retiree
 15 medical costs represent a huge financial risk for the City. *See supra* Section III(C)(4)(b)(4). Any
 16 successful plan of adjustment must address this expenditure, as did the ask. Unlike with
 17 employee groups that are the designated representatives for their members under California law,
 18 outside of bankruptcy the more than 1,000 affected retirees have no representative who can bind
 19 them.⁷ In fact, as in *Vallejo*, the City does not even have contact information for some retirees
 20 and must send notice to them via CalPERS. Burke Decl., ¶ 51. This inability to bind or even to
 21 contact some retirees, standing alone, made any negotiations with the City’s creditors ultimately
 22 impracticable.

23 **F. The City Filed Its Petition In Good Faith.**

24 Even assuming the City can satisfy the requirements of § 109(c), a distinct requirement
 25 under the Code, which the City satisfies here, is that the debtor “file the petition in good faith.”

26 _____
 27 ⁷ A group that claimed the authority to bind a significant number of Stockton’s retirees participated in the AB 506
 28 process under the title “Association of Retired Employees of the City of Stockton” (“ARECOS”). Even if this group
 had authority to bind the number of members it claimed to represent, though, it represented fewer than 25% of the
 City’s total retiree population of approximately 2,400.

1 11 U.S.C. § 921(c). Courts and commentators have looked at a number of factors to determine
2 whether the debtor acted in good faith. *Pierce County*, 414 B.R. at 714; *OTB*, 427 B.R. at 278.
3 These include: (i) the debtor’s subjective beliefs; (ii) whether the debtor’s financial problems fall
4 within the situations contemplated by chapter 9; (iii); whether the debtor filed its chapter 9
5 petition for reasons consistent with the purposes of chapter 9; (iv) the extent of the debtor’s
6 prepetition negotiations, if practicable; (v) the extent that alternatives to chapter 9 were
7 considered; and (vi) the scope and nature of the debtor’s financial problems. *Pierce County*, 414
8 B.R. at 714. In *Pierce County*, the court found the petition filed in good faith where the debtor
9 made the decision to “file Chapter 9 only after several years of negotiations and attempts at
10 mediation failed.” Similarly, in *OTB*, the petition was in good faith in part because it was “not
11 filed merely to delay payments to its creditors or as a litigation tactic.” *OTB*, 427 B.R. at 280.

12 Chapter 9 is truly a last resort for Stockton. The Great Recession wrought once-in-a-
13 lifetime economic reversals to a City that was particularly vulnerable. The collapse in home
14 prices, employment rates, and revenues has left the City with an incurable structural imbalance in
15 its finances. *See supra* Section II(A). The human toll of the recession is seen every day as fewer
16 police protect increasingly worried residents and businesses, many of whom also are struggling
17 financially. *Id.*

18 For years, the City strove at all costs to avoid filing a chapter 9 case. It has balanced its
19 budget by aggressively reducing expenses, to the point where further reductions would jeopardize
20 public health and safety. It has missed bond payments and deferred leave payments. Throughout
21 this process, the City has engaged in ongoing negotiations with its labor groups for years, and
22 won major concessions along the way. *See supra* Section II(A).

23 Nevertheless, when another fiscal cliff loomed and there was not enough left to cut, the
24 City confronted head-on the possibility that it might have to seek bankruptcy protection. *See*
25 *supra* Section II(A)(3). It therefore participated in good faith (a distinct state law requirement) in
26 the AB 506 process. *See supra* Section II(B) There it developed an ask, met and communicated
27 many times with those creditors willing to participate, and demonstrated its genuine desire to
28 restructure its financial obligations outside of bankruptcy, if possible. *Id.* Only when this process

